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Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws

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Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws

Cover Page Footnote

International Law; Commercial Law; Law

Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws

*Jerry W. Markham**

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Introduction

The New Deal legislation that was enacted during the Great Depression imposed a pervasive regulatory structure over the securities industry,¹ as well as defining the role of banks in the

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¹ The securities industry was subject to intense regulation during the Great Depression through a series of six statutes: the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (2000) (requiring public offerings of securities to be accompanied by a prospectus and to be registered with the Securities and Exchange Commission (SEC)); the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (2000) (imposing regulation over broker-dealers and trading markets and establishing voting and periodic reporting requirements

economy,² and increasing the regulation of derivatives trading.³ At the end of the twentieth century, however, Congress began to dismantle significant pieces of this dated regulatory structure. Most prominently, the Gramm-Leach-Bliley Act of 1999 (GLBA)⁴ repealed the provisions of the Glass-Steagall Act⁵ that had separated investment banking from commercial banking. GLBA now allows commercial banks, through "financial holding companies," to engage in merchant banking⁶ and to participate in the insurance business.⁷ Restrictions on interstate banking and branching had been repealed even earlier.⁸

on publicly held companies); the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79a *et seq.* (simplifying the holding company structures for public utility companies); the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa *et seq.* (2000) (imposing requirements on trustees of public bond sales sold under indenture agreements); the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* (2000) (requiring registration of investment advisors and imposing record keeping and other requirements); and the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* (2000) (regulating closed and open end investment companies). *See* THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION (4th ed. 2001) (providing a general description of the federal securities laws).

² *See* the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

³ *See* the Commodity Exchange Act of 1936, 15 U.S.C. § 1 *et seq.* (2000) (regulating futures trading); JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION (1987) (describing the history of the Commodity Exchange Act).

⁴ Pub. L. No. 106-102 (codified as amended at 12 U.S.C. §§ 1811-1832).

⁵ The Glass-Steagall Act was a part of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). *See generally* Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988) (describing Glass-Steagall provisions).

⁶ 12 U.S.C. § 1843(k)(4)(H) (2000). Merchant banking is simply a reference to instances where banks take equity investments in non-public companies. Prior to GLBA, banks could make only limited investments in commercial firms. That restriction was loosened by GLBA, but bank regulators still limit the amount and duration of merchant banking investments in order to prevent the creation of industrial banks. 12 C.F.R. § pt. 225. *See generally* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES, CASES AND MATERIALS 758-59 (2001) (description of GLBA merchant banking provisions).

⁷ 12 U.S.C. § 1843(k)(4)(B) (2000).

⁸ The McFadden Act of 1927 and the Banking Act of 1933 had subjected national banks to the branching restrictions of the individual states. 12 U.S.C. § 36(c) (2000). The Douglas amendment to the Bank Holding Company Act also precluded interstate banking by national banks. 12 U.S.C. § 1842(d) (2000). The Riegle-Neal Interstate

In another financial sector, the Commodity Exchange Act of 1936, which had confined futures trading to regulated “contract markets,” was revamped with the adoption of the Commodity Futures Modernization Act of 2000 (CFMA).⁹ That legislation authorized the creation of virtually unregulated off-exchange markets for institutions in derivative instruments, leaving only a regulated structure over retail markets where small customers participate.¹⁰ A much larger sector of finance—insurance—remains unregulated by the federal government.¹¹

In contrast to these events, with the exception of strengthening amendments passed in the aftermath of various scandals,¹² the federal securities laws remain pretty much in the form arrived at in the 1930s. This seems strange in light of the dynamic changes in the securities industry in the latter half of the last century. The creation of the Internet, the integration of derivatives, the development of electronic trading systems, and the growth of global markets transformed the securities markets, leaving only a few vestiges of the industry that existed when the federal securities laws were enacted.

Of equal note is the fact that full disclosure under the federal securities laws does not seem to be accomplishing its goals. That concept hinges on the accuracy and integrity of accounting statements. There is much evidence that those statements are

Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338, struck those restrictions on branching and interstate banking. States were allowed to opt in or out of these provisions. Most states decided to allow interstate branching and banking. For a description of interstate and branching restrictions and their removal, see Hayley M. Brady & Mark V. Purpra, Note, *The Riegle-Neal Amendments Act of 1997: The Impact of Interstate Branching on the Dual Banking System*, 2 N.C. BANKING INST. 230 (1998).

⁹ Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.).

¹⁰ CFMA (Title III, § 303) subjected swap transactions involving securities to the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), but not to the registration or other requirements of the federal securities laws. *Caiola v. Citibank, N.A.*, 295 F.3d 312 (2d Cir. 2002) (describing application of Section 10(b) to securities swaps).

¹¹ See Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 IOWA J. CORP. L. 723 (2000) (describing efforts to impose federal regulation).

¹² See *infra* notes 211–264 and accompanying text.

seriously flawed. The collapse of the Enron Corporation turned out to be an accounting scandal of historic proportions. It was followed by others, including WorldCom, Inc., which became the largest bankruptcy ever. A flood of restated earnings were reported by other companies that were fudging their earnings in an attempt to escalate the market price of their stock.¹³ Analysts were accused of being touts, rather than conductors of objective examinations of company prospects.

The Enron-telecom-analysts scandals track, in many ways, those scandals occurring before the stock market crash of 1929, which the SEC was created to prevent. This was not its only failure. The federal securities laws failed to stop the market bubble of the 1990s that burst in 2000 and continued to plunge in the following years.¹⁴ The market run up was, if anything, greater than that of the 1920s, and the fall nearly as precipitous. Estimates have ranged as high as \$8.5 trillion as to the market value lost during the market reverse that began in 2000.¹⁵ How did full disclosure aid investors in this debacle?

This article will describe the background of the federal securities laws and the assumptions about full disclosure that were made to justify this intrusive legislation. Problems encountered by the SEC in the nearly seven decades that have passed since the Stock Market Crash of 1929 are also considered. Then, the article reviews the market meltdown over the last three years and describes how full disclosure regulation failed. It then focuses on a principal flaw in the system—the misguided effort to turn accountants into policeman.

¹³ See *infra* notes 318–411 and accompanying text.

¹⁴ Anitha Reddy, *A Dismal 2002 Ends Quietly on Wall Street*, WASH. POST, Jan. 1, 2003, at E1.

¹⁵ *Cutting Interest Rates Won't Halt Deflation*, POST-DISPATCH, Nov. 5, 2002, at B6. The S&P 500 Index was more resilient, but it fell by fifteen percent during 2001. This was the second year that index fell more than ten percent. Alex Berenson, *Prognosis for Stocks Brightens After 2 Years of Big Declines*, N.Y. TIMES, Jan. 2, 2002, at C1.

The Federal Securities Laws

Before the SEC

The myth has arisen that America owes its dominant place in finance to the transparency required by the federal securities laws.¹⁶ That transparency, and tough enforcement by the SEC, is said to have reestablished investor confidence in the market after the stock market crash of 1929 and encouraged investment. In fact, the United States had achieved financial dominance well before the adoption of the federal securities laws and the creation of the SEC in the 1930s.¹⁷ The capital raising efforts and speculations of the Robber Barons of the nineteenth century¹⁸ and the growth of the more professional investment bankers such as J.P. Morgan & Co. and E.H. Harriman¹⁹ laid the foundation for American financial leadership.

At the beginning of the twentieth century, the investment bankers were consolidating whole industries, making them more efficient and competitive on the world stage.²⁰ They created a national economy and provided vast amounts of new finance for what were then fledgling hi-tech industries such as automobiles, electricity, telephones, radios, and motion pictures.²¹ At the time of the outbreak of World War I, these financiers controlled vast

¹⁶ See generally Thomas Russo, *Rationalizing Risk*, FIN. TIMES (LEXIS), July 21, 1998, at 12 (discussing transparency concept); Dan Gerstenfeld, *Don't Bank on It*, JERUSALEM POST (LEXIS), Dec. 21, 2000, at 15 (discussing transparency concept).

¹⁷ JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, in vols. I–III (2001) (describing the growth of America's role in finance).

¹⁸ The robber barons included Cornelius Vanderbilt, Daniel Drew, Jay Gould, and James Fisk. See generally MAURY KLEIN, THE LIFE AND LEGEND OF JAY GOULD (1986); WHEATON J. LANE, COMMODORE VANDERBILT: AN EPIC OF THE STEAM AGE (1942) (describing the robber barons).

¹⁹ See generally RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE (1990); MAURY KLEIN, THE LIFE AND LEGEND OF E.H. HARRIMAN (2000) (description of these financiers).

²⁰ These activities included a reorganization of the railroad industry and the combination of steel companies into U.S. Steel, the first billion-dollar corporation. See generally DOLORES GREENBERG, FINANCIERS AND RAILROADS, 1869–1889 (1980) (describing reorganization of railroads); JOHN MOODY, THE MASTERS OF CAPITAL: A CHRONICLE OF WALL STREET 80–83 (1919) (description of U.S. Steel combination).

²¹ See MAURY KLEIN, RAINBOW'S END: THE CRASH OF 1929 108, 115 (2001) (describing the growth of manufacturing before the Stock Market Crash of 1929).

amalgamations of capital and could raise enormous sums for investment through sophisticated underwriting methods.²² That skill proved handy when the European nations turned to America to fund their armies. America responded by providing a significant portion of the capital used to wage that conflict, while at the same time allowing America to field its own forces. The United States was the financial, as well as the political, center of the world at the conclusion of that war.²³

Regulation of securities trading and sales was largely a matter of state law before the advent of the SEC. That regulation was limited.²⁴ Gambling statutes were used to proscribe betting on stock price changes.²⁵ An established body of case law governed the duties of brokers to customers.²⁶ Stockbrokers, for example, were held to owe fiduciary duties to their customers for whom they were acting as agents.²⁷ The states exercised some direct regulatory control through laws governing corporations and their charters. New Jersey had broken new ground in this area by allowing corporations to have broad corporate powers and by allowing holding company structures. This allowed the trusts, such as Standard Oil, which were then under attack, to operate legally.²⁸

²² J.P. Morgan & Co. was among the leading investment bankers that led these capital-raising efforts. *Id.*

²³ See HERBERT D. SEIBERT & CO., *THE BUSINESS AND FINANCIAL RECORD OF THE WORLD WAR YEARS* (1975) (describing the finance provided by American markets to the World War I belligerents (including Germany until America entered the war)). The United States was a net creditor as early as 1895. Charles R. Morris, *From Merchants to Bankers*, WALL ST. J., April 2, 2003, at D8. The United States was also a net creditor during World War I. ALLAN H. MELTZER, *A HISTORY OF THE FEDERAL RESERVE* (1913–1951) 83, n. 37 (2003).

²⁴ New York prohibited short sales in 1812, but that legislation was repealed several years later. J. EDWARD MEEKER, *SHORT SELLING* 231–32 (1932).

²⁵ *Justh v. Holliday*, 2 Mackey 346 (1883) (“difference” trading on stocks held to be gambling).

²⁶ See generally JOHN R. DOS PASSOS, *A TREATISE ON THE LAW OF STOCKBROKERS AND STOCK EXCHANGES* (1882) (description of case law on stockbroker obligations before the adoption of the federal securities laws); CHARLES H. MEYER, *THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES* (1931) (description of case law on stockbroker obligations before the adoption of the federal securities laws).

²⁷ *Markham v. Jaudon*, 41 N.Y. 235, 244–45 (1869).

²⁸ See PETER KRASS, *CARNEGIE* 257 (2002) (describing the operation of the Standard Oil Trust).

Other states mimicked this practice.²⁹

Some states established regulatory commissions to supervise their corporations or assigned the Secretary of State that duty.³⁰ In 1903, Connecticut required mining and oil companies to file a certificate with the Secretary of State that described their finances and their drilling or mining activities.³¹ Seven years later, Rhode Island required out-of-state issuers of securities to file financial reports with the Secretary of State.³² Kansas enacted the first “blue sky” law in 1911.³³ It required companies selling securities in Kansas to register with the bank commissioner and disclose information about their operations. Stockbrokers were required to be registered.³⁴ The Kansas legislation became a model for other states. Over twenty states adopted some form of blue sky law shortly after the enactment of the Kansas legislation.³⁵

In New York, brokers were prohibited from hypothecating customer securities without their consent, except to the extent the securities were being posted on margin.³⁶ The state also prohibited false or misleading rumors, statements, or advertisements in

²⁹ Just before leaving the Governor’s office to become President, however, Woodrow Wilson signed legislation that barred the incorporation of holding companies in New Jersey. KENDRICK A. CLEMENTS, *WOODROW WILSON, WORLD STATESMAN* 71 (1987). The large corporations then moved their charters to Delaware, which dedicated itself to providing favorable conditions for large businesses. ROBERT F. HIMMELBERG, *BUSINESS AND GOVERNMENT IN AMERICA SINCE 1870* 688–89 (1994); FREDERICK LEWIS ALLEN, *THE LORDS OF CREATION* 255 (1935); see *Louis K. Liggett Co. v. Lee*, 288 U.S. 517 (1933) (Brandeis, J., dissenting) (providing a critical description of the growth of enabling corporate laws).

³⁰ H.R. Rep. No. 62-1593, at 151 (1913).

³¹ LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* 5 (1958).

³² *Id.* at 6.

³³ DAVID SAUL ROBERTS, *REGULATING THE SECURITIES INDUSTRY: THE EVOLUTION OF A GOVERNMENT POLICY* 24–25 (1969).

³⁴ LOSS & COWETT, *supra* note 31, at 4; VINCENT P. CAROSSO, *INVESTMENT BANKING IN AMERICA, A HISTORY* 162 (1970); ROBERTS, *supra* note 33, at 25.

³⁵ Between 1910 and 1933, blue sky laws were adopted in all of the states except Nevada. LOSS & COWETT, *supra* note 31, at 17; WILLIAM J. SHULTZ & M. R. CAINE, *FINANCIAL DEVELOPMENT OF THE UNITED STATES* 602 (1937). The Supreme Court upheld the constitutionality of these state statutes. *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stockyard Co.*, 242 U.S. 559 (1917); *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568 (1917).

³⁶ MEYER, *supra* note 26, at 331; RAYMOND VERNON, *THE REGULATION OF STOCK EXCHANGE MEMBERS* 30 (1941).

connection with the sale of securities.³⁷ New York additionally prohibited bucket shops, manipulation, and fictitious transactions.³⁸ The Martin Act—adopted in 1921—sought to curb securities fraud scandals that were occurring after World War I.³⁹ That act authorized the New York attorney general to investigate and seek injunctions against fraudulent securities practices or manipulative activities.⁴⁰ The Martin Act was a broad based anti-fraud measure, rather than a disclosure device.⁴¹ It would become a popular means for the New York Attorney General, Elliot Spitzer, to establish near predominance over securities regulation in this century.⁴²

One area that was not generally regulated was trading by corporate insiders of their own company's stock using inside information. Most state courts held that insiders could trade freely in their company's securities.⁴³ Margin trading was supported by the "call money" market in New York that allowed banks to make short-term loans using securities as collateral. The call money market was unregulated even though it "played a role in all major financial crises from 1873 to 1907."⁴⁴

³⁷ WILLIAM HARMON BLACK, *THE LAW OF STOCK EXCHANGES, STOCK BROKERS & CUSTOMERS* 146-48 (1940).

³⁸ MARGARET G. MYERS, *THE NEW YORK MONEY MARKET, ORIGINS AND DEVELOPMENTS* 313-14 (1931).

³⁹ The Martin Act was passed in 1921 but was not funded for enforcement by the New York Attorney General until 1923. In the Matter of Ottinger, 148 N.E. 627 (Ct. App. N.Y. 1925).

⁴⁰ LOUIS LOSS, *SECURITIES REGULATION* 21-23 (1951).

⁴¹ *Bishop v. Commodity Exchange, Inc.*, 564 F. Supp. 1557, 1565 (S.D.N.Y. 1983).

⁴² See *infra* notes 314-411 and accompanying text.

⁴³ See e.g., *Carpenter v. Danforth*, 52 Barb. 581, 584 (N.Y. 1868); see also *Goodwin v. Agassiz*, 186 N.E. 659, 661-62 (Mass. 1933). A few states required disclosures of non-public information by insiders when dealing face-to-face, as exemplified by the Supreme Court's creation of something called the "special facts" doctrine, which required insiders to disclose facts of a particularly important nature. *Strong v. Repide*, 213 U.S. 419 (1909).

⁴⁴ *A Study by the Staff of the Board of Governors of the Federal Reserve System, A Review and Evaluation of Federal Margin Regulations* 44 (Dec. 1984).

Federal Regulatory Efforts

The earliest efforts to regulate the issuance and trading of corporate securities on the federal level seems to have begun with charter limitations imposed by Alexander Hamilton on the Bank of the United States. Among other things, the bank's charter imposed voting restrictions on large shareholders, and the Treasury Department was authorized to inspect its records and audit its accounts and financial condition.⁴⁵ The National Banking Act of 1863 also created a class of federally chartered banks that were subjected to direct federal supervision by the Treasury Department, but this was not disclosure legislation.⁴⁶ The Interstate Commerce Act of 1887 was another effort to regulate corporations; directed mostly at railroad activities, it too did not choose disclosure as a regulatory model.⁴⁷ Broader in reach was the Sherman Anti-Trust Act that was passed in 1890,⁴⁸ but it was only a blunt tool that had little direct application to securities trading.⁴⁹

There was no full disclosure available for shareholders before the adoption of the federal securities laws in the 1930s.

⁴⁵ A. BARTON HEPBURN, *HISTORY OF COINAGE AND CURRENCY IN THE UNITED STATES AND THE PERENNIAL CONTEST FOR SOUND MONEY* 457–59 (1903). The creation of the Bank of the United States touched off a debate in George Washington's cabinet over whether the federal government had the power to charter corporations. Washington decided that Congress did have such an implied power, and the Supreme Court subsequently confirmed that authority in *McCulloch v. Maryland*, 17 U.S. 316 (1819). Congress has never used its chartering power broadly, and proposals to create a universal federal charter as a means of increasing regulation over corporations who often chartered in the state having the most lax laws (*i.e.*, Delaware) have never gained much support. See JAMES D. COX, ET AL., *CORPORATIONS*, § 2.11 (1995) (describing federal chartering proposals).

⁴⁶ Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 228 (2000). An effort to regulate futures trading in gold during the Civil War lasted a mere two weeks before its repeal. MARKHAM, *supra* note 3, at 7 (1987).

⁴⁷ KLEIN, *supra* note 19, at 76.

⁴⁸ 15 U.S.C. § 1 (2000).

⁴⁹ After World War II, the government would use the antitrust laws as the basis for a massive but unsuccessful attack on investment bankers. *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953). More successful were suits brought against Nasdaq market-makers for colluding on quotes during the 1990s. JERRY W. MARKHAM & THOMAS L. HAZEN, *BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW* § 2.09[7] (2000).

Prospectuses used to sell stocks were "little more than notices."⁵⁰ There was no authority for the government to compel disclosures on the finances of publicly traded stocks. The American Sugar Refining Company even refused to report to the Census Bureau.⁵¹ Although the New York Stock Exchange required some financial reporting by "listed" companies, "unlisted" companies traded on that exchange—such as the American Sugar Refining Company—were not required to provide any financial information.⁵²

A Bureau of Corporations was created in the Department of Commerce and Labor after the turn of the century as a means of gathering information on large corporations, but it had little success and was merged into the Federal Trade Commission in 1914.⁵³ Before its demise, the Bureau of Corporations sought to have congress adopt a federal charter requirement that would give it control over large corporations but that too was a non-starter.⁵⁴ The first serious inquiry on the federal level for regulating securities activities seems to have been that of the Industrial Commission in 1898. It sought federal legislation to stop short selling, which was thought to be the cause of market breaks that resulted in large losses to shareholders.⁵⁵ The Industrial Commission further recommended that corporations be required to provide shareholders with annual financial reports. Those recommendations were not adopted.

More important to the effort to impose federal regulation was the congressional investigation that followed the Panic of 1907, which sought to determine if there was a money trust that was controlling American business. That inquiry was the result of the muckraking journalists and "progressive" legislators such as Charles Lindbergh, a congressman from Minnesota and the father

⁵⁰ *Morgan*, 118 F. Supp. at 639.

⁵¹ JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES, FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900)* 333 (2002) [hereinafter I MARKHAM].

⁵² *Id.* at 4.

⁵³ RICHARD KLUGER, *ASHES TO ASHES* 46 (1996); LOSS, *supra* note 40, at 59–60.

⁵⁴ ROBERTS, *supra* note 33, at 35.

⁵⁵ Congress Investigates "Short" Selling Practices, xi Congressional Digest, No. 12, at 291 (Dec. 1932). This proposal is now being revived as a way to control market prices. See *infra* notes 465–466.

of the famous flier.⁵⁶ Lindbergh's claims led to a congressional investigation conducted by the House Committee on Banking, chaired by Arsene Pujo of Louisiana.⁵⁷ The Committee did indeed find that J.P. Morgan & Co., the First National Bank, the National City Bank, and a few others controlled vast railroad and other enterprises through interlocking directorships.⁵⁸ The Pujo Committee also discovered numerous abuses in the securities markets, including insider trading.⁵⁹

Despite these revelations, Congress did not choose to regulate the securities markets. Instead, it passed the Clayton Antitrust Act⁶⁰ and created the Federal Trade Commission⁶¹ in order to stop non-competitive practices and abuses of interlocking directorships. The financial regulatory structure was enhanced in 1913 with the creation of the Federal Reserve System. That institution was formed in the aftermath of the Panic of 1907 at the behest of a group of bankers and was intended to assure that there was adequate liquidity in the money markets during times of stress.⁶²

The next serious effort to regulate securities trading arose during World War I. The Liberty Loan Committee in New York, which was administered with the Federal Reserve Board (Fed), established a subcommittee on money rates (the Money Committee) that sought to regulate the call money market to assure adequate liquidity so as to avert market panics.⁶³ The Treasury Department and the Fed also formed a Capital Issues Committee (CIC) that at first operated on a voluntary basis but was later given congressional authority to require submission of

⁵⁶ A. SCOTT BERG, LINDBERGH 75 (1998).

⁵⁷ H. Rep. No. 62-1593 (1913).

⁵⁸ *Id.* at 131.

⁵⁹ *Id.* at 43. An earlier investigation by the New York Governor Charles E. Hughes's Committee on Speculation in Securities and Commodities that was conducted after the Panic of 1907 had also found numerous abuses in securities trading. W. C. VAN ANTWERP, *THE STOCK EXCHANGE FROM WITHIN* 419 (1913).

⁶⁰ MYERS, *supra* note 38, at 299.

⁶¹ ALLEN, *supra* note 29, at 191.

⁶² Markham, *supra* note 46, at 228-31.

⁶³ LESTER V. CHANDLER, BENJAMIN STRONG, *CENTRAL BANKER* 124-27 (1958); *The Financial Situation: No Funds for Big Speculative Market*, N. Y. TIMES, Sept. 2, 1918, at 10; BENJAMIN HAGGOTT BECKHART, *THE NEW YORK MONEY MARKET* 65 (1932); SHULTZ & CAINE, *supra* note 35, at 568-69.

security issues for review and approval. The CIC reviewed securities offerings in excess of \$100,000 to ensure that they were compatible with the war effort.⁶⁴ This was basically a way to bar speculative enterprises from tapping the capital markets. Unless approved as meeting that standard, securities offerings could not go forward. Before concluding its operations, the CIC submitted a report to Congress recommending the continuance of its operations after the war. The committee reported that market operators were fleecing unsophisticated individuals through schemes in which valuable Liberty bonds were exchanged for worthless securities. The CIC concluded that state blue sky laws were inadequate to deal with such problems. Congress failed to respond to the CIC's concerns.⁶⁵

The CIC had administered a substantive review process for approving the use of funds being raised by underwritings, but the legislation it sought was disclosure based. President Woodrow Wilson asked Congress for such legislation in order to "stop speculation and to prevent the fraudulent methods of promotion by which our people are annually fleeced on many millions of hard earned money."⁶⁶ This legislation was not adopted, but the Fed, at the urging of the Secretary of Commerce, did publish a pamphlet in 1917 entitled "Approved Methods for the Preparation of Balance Sheets."⁶⁷

The Stock Market Crash and the New Deal

The causes of the Stock Market Crash of 1929 and the ensuing Great Depression are still debated.⁶⁸ Various blamed are

⁶⁴ HERBERT D. SEIBERT & CO., *THE BUSINESS AND FINANCIAL RECORD OF WORLD WAR YEARS* 267 (1975); WOODBURY WILLOUGHBY, *THE CAPITAL ISSUES COMMITTEE AND WAR FINANCE CORPORATION* 17 (1934); CAROSSO, *supra* note 34, at 231.

⁶⁵ REPORT OF THE CAPITAL ISSUES COMMITTEE, H.R. DOC. NO. 65-1836, at 2-3 (1919).

⁶⁶ *Securities Act: Hearings Before the Senate Comm. on Banking and Currency* on S. 875, 73d Cong. 315 (1934).

⁶⁷ JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900-1970)* 91 (2001) [hereinafter II MARKHAM]. President Calvin Coolidge rejected a request made by Professor William Z. Ripley to have the Federal Trade Commission require corporations to file financial reports. The President thought this was a matter better left to the states. *Id.* at 128.

⁶⁸ KLEIN, *supra* note 19, at xiii. "Nobody has ever established a clear and conclusive link between the events of October 1929 and the 1930s depression." *Wall Street Crash, Parallel Bars*, *THE ECONOMIST*, Oct. 27, 2001, at 81.

excessive speculation through margin accounts and abusive market practices such as the organized pools that were operating in over one hundred New York Stock Exchange stocks.⁶⁹ Margin trading was claimed to have induced excessive speculation and soaked up credit needed for industrial use.⁷⁰ More recent focus has centered on the blunders of the Fed, which first eased credit in order to support England's effort to return to the gold standard, thereby boosting the market. The Fed then reversed course and sought to curb the market through ill-conceived interest rate increases.⁷¹ These blunders would be repeated in the market meltdown that began in 2000.⁷²

New York Governor Franklin Roosevelt sought and won the presidency on a platform of attacking the financiers and advocating legislation that would effectively cripple them.⁷³ This was not an original plan. Franklin Roosevelt had modeled his career after that of his cousin, Theodore, both having served as Assistant Secretary of the Navy and Governor of New York.⁷⁴ Theodore Roosevelt had also used attacks on the financiers to bolster his populous image. One such set of attacks was said to have demoralized the market and caused the stock market panic of 1907. He attacked the "tyranny of mere wealth,"⁷⁵ and his charges

⁶⁹ S. Rep. No. 1455, at 32-33 (1933).

⁷⁰ S. Rep. No. 792, at 3 (1934); *Stock Exchange Regulation, Hearings Before the House Comm. on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720*, 73d Cong. 2d Sess. 68 (1934).

⁷¹ KLEIN, *supra* note 19, at 132-34, 188. See generally II MARKHAM, *supra* note 67, at 151 (describing changes by the Fed in interest rate policy and market plunge).

⁷² See *infra* notes 190-210 and accompanying text.

⁷³ Among other things, Roosevelt asserted that "the day of the great promoter or the financial Titan, to whom we granted everything as only he would build, or develop, is over." DAVID M. KENNEDY, *FREEDOM FROM FEAR, THE AMERICAN PEOPLE IN DEPRESSION AND WAR* 373 (1999). Ironically, Governor Franklin Roosevelt was the only person in America with the power to have regulated the stock markets before their crash. The New York Martin Act, which is now being used to regulate the markets nationally by the New York attorney general, was already on the books for Franklin Roosevelt to invoke, or at least demand that state and local prosecutors employ.

⁷⁴ See FRANK FREIDEL, *FRANKLIN ROOSEVELT, A RENDEZVOUS WITH DESTINY* 16-17, 23, 54-55 (1990) (describing Franklin's admiration for Theodore and parallel offices); EDMUND MORRIS, *THE RISE OF THEODORE ROOSEVELT* 691-709 (1979) (describing Theodore Roosevelt as governor of New York).

⁷⁵ NATHAN MILLER, *THEODORE ROOSEVELT, A LIFE* 365 (1992).

against the "malefactors of great wealth" was said to have undermined confidence in the business community before the Panic of 1907.⁷⁶ Theodore Roosevelt's trust busting lawsuits added to the demagoguery directed against business that frequently marked his administration.⁷⁷ Theodore too had called for the creation of a federal commission to regulate securities,⁷⁸ a demand that Franklin would mimic and would succeed in implementing through the Securities Exchange Act of 1934. Franklin also copied Theodore's populist attacks on the financiers. Franklin attacked the financiers with statements such as: the "practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men," and that "the money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths."⁷⁹

The congressional investigations that followed the stock market crash of 1929 did little more than replicate the hearings that followed the stock market panic of 1907. Both sought a "money trust" on which to blame the country's economic woes.⁸⁰ Both focused on margin, insider abuses, manipulation, and excessive speculation.⁸¹ The difference was that a demoralized congress in the 1930s was only too happy to find and punish scapegoats. Wall Street made a nice bogeyman. After all, who could feel sorry for a financier, a class that is, impossibly, even less popular than lawyers, particularly in times of market declines. The result was the enactment of the federal securities laws. Those

⁷⁶ CHERNOW, *supra* note 19, at 538.

⁷⁷ MILLER, *supra* note 75, at 366-67.

⁷⁸ *Id.* at 365.

⁷⁹ JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 19 (1995). The legislative history of the federal securities laws is full of charges that speculative "orgies" and excessive speculation were occurring in the markets. *See e.g.*, S. Rep. No. 1455, at 9 (1934) (reference to speculative orgies); S. Rep. No. 792, at 3 (1934) (reference to uncontrolled speculation).

⁸⁰ For a description of the hearings that followed the stock market panic of 1907, see *supra* notes 55-62 and accompanying text.

⁸¹ For the issues addressed in the hearings following the stock market crash of 1929, see S. Rep. No. 1455, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933).

statutes sought to provide the investor with “complete and truthful information from which he may intelligently appraise the value of a security, and to safeguard against the negligent and fraudulent practices perpetrated upon him in the past by incompetent and unscrupulous bankers, underwriters, dealers, and issuers.”⁸²

The federal securities laws, despite all the ballyhoo, did not end the Great Depression. Controversy exists over what caused and prolonged the Great Depression. Some claimed that the market crash caused the depression, *post hoc ergo propter hoc*.⁸³ Indeed, recessions and depressions often followed a market crash. The depression that began in 1893 was particularly prolonged and deep.⁸⁴ But that claim does no more than suggest that the market anticipates the economic decline. The current view seems to be that the stock market crash of 1929 “was probably an event of relatively minor significance” in causing the Great Depression.⁸⁵ Others suggest that the tariff wars raging around the world as the depression worsened prolonged and deepened its effects by almost stopping international trade.⁸⁶ More blundering by the Federal Reserve pushed the country back into depression when a recovery appeared imminent in 1937.⁸⁷ As the *Economist* noted, the depression “was caused by wrong-headed monetary and fiscal policy, combined with the Smoot Hawley tariffs, and not by happenings on Wall Street.”⁸⁸

⁸² S. Rep. No. 1455, 73d Cong. 2d Sess. 153 (1934).

⁸³ For example, in a message to Congress, President Franklin Roosevelt asserted that “unregulated speculation in securities and commodities was one of the most important contributing factors in the artificial and unwarranted ‘boom’ which had so much to do with the terrible conditions of the years following 1929.” H.R. Rep. No. 421, 74th Cong., 1st Sess. 2 (1935).

⁸⁴ CHARLES HOFFMAN, *THE DEPRESSION OF THE NINETIES: AN ECONOMIC HISTORY* 4 (1970).

⁸⁵ CHARLES R. MORRIS, *MONEY, GREED, AND RISK: WHY FINANCIAL CRISES AND CRASHES HAPPEN* 73 (1999).

⁸⁶ KENNEDY, *supra* note 73, at 49, n.12. World Trade declined by some two-thirds between 1929 and 1933. ANTHONY S. CAMPAGNA, *U.S. NATIONAL ECONOMIC POLICY 1917–1985* 79 (1987).

⁸⁷ See WILLIAM GREIDER, *SECRETS OF THE TEMPLE* 321 (1987) (discussing Fed actions in 1937). Additional attacks on Wall Street by Franklin Roosevelt during the 1936 elections further undermined confidence in the market. See KENNEDY, *supra* note 86, at 280 (describing Roosevelt’s attacks).

⁸⁸ *Wall Street Crash, Parallel Bars*, *THE ECONOMIST*, Oct. 27, 2001, at 81.

The enactment of the Glass–Steagall Act assured that the investment bankers would be too weak to lead a recovery.⁸⁹ They were cut off from the financial strength provided previously by commercial banks.⁹⁰ The enactment of the federal securities laws also added further burdens. The investment bankers turned to private placements with large institutions, which were not covered by the registration requirements.⁹¹ In many instances, this involved insurance companies that wanted only fixed income instruments. That dependency on debt resulted in a distortion of corporate balance sheets, as they increased debt and reduced equity positions.⁹² This market was unavailable to small and medium size entrepreneurs.⁹³ Rational entrepreneurs avoided the retail markets in raising capital, leaving small investors with only those offerings that could not be placed elsewhere.

Applying Federal Regulation

New Deal programs and spending relieved much of the hardship but did nothing to restart the American economy. Government spending was a poor substitute for the stock markets and the capital raising efforts of private firms. The Great Depression ended only after war broke out in Europe.⁹⁴

The war restarted the economy, not the SEC. Indeed, the SEC, not surprisingly, was declared a non-essential agency during World War II. It was shipped off to Philadelphia,⁹⁵ an ignominy

⁸⁹ U.S. v. Morgan, 118 F. Supp. 621, 647 (S.D.N.Y. 1953).

⁹⁰ New private investments in the middle of the depression were about one-third of the level for 1929. KENNEDY, *supra* note 73, at 351. As one author noted: "Capital, in short, was hibernating." *Id.*

⁹¹ A "striking" change in finance was the increase in private placements that followed the creation of the SEC. IRWIN FRIEND ET AL., INVESTMENT BANKING AND THE NEW ISSUES MARKET 28–29 (1967).

⁹² TEMPORARY NATIONAL ECONOMIC COMMITTEE, 76TH CONG., 3D SESS., INVESTIGATION OF CONCENTRATION OF ECONOMIC POWER, Monograph No. 28, 377–378 (1940).

⁹³ *Id.* at 378.

⁹⁴ The gross national product of the United States doubled between 1939 and 1945. JAMES T. PATTERSON, GRAND EXPECTATIONS, THE UNITED STATES, 1945–1974 56 (1996).

⁹⁵ II MARKHAM, *supra* note 67, at 265.

that still rankled SEC staff members thirty years later.⁹⁶ The stock markets continued to languish until after the end of World War II, when the consumer economy began to boom. However, it was not until November 17, 1954 that the market returned to its 1929 high, under a more business friendly Eisenhower administration.⁹⁷ The Dow Jones Industrial Average tripled during the 1950s⁹⁸ as the SEC lay moribund.⁹⁹

During the 1950s, institutional investors began firmly entrenching themselves in the market.¹⁰⁰ Their strength grew. By 1990, the institutional investor dominated the capital markets.¹⁰¹ Individual investors were net sellers of stock at the rate of about 3.5 million shares per day.¹⁰² This result is not surprising, as many small investors found themselves being fleeced by penny stock promotions after the war.¹⁰³ These promotions included speculative forays into technology stocks, which presaged the Internet boom of the 1990s,¹⁰⁴ and various schemes concocted by

⁹⁶ *Id.*

⁹⁷ ROBERT SOBEL, N.Y.S.E., A HISTORY OF THE NEW YORK STOCK EXCHANGE, 1935–1975 225 (1975).

⁹⁸ MONICA LANGLEY, TEARING DOWN THE WALLS, HOW SANDY WEILL FOUGHT HIS WAY TO THE TOP OF THE FINANCIAL WORLD . . . AND THEN NEARLY LOST IT ALL 18 (2003).

⁹⁹ “[L]iterally and figuratively, the S.E.C. slept for most of the decade.” JOHN BROOKS, THE GO-GO YEARS 84 (1984).

¹⁰⁰ “Due largely to the impact of the income and inheritance tax laws, the importance of the individual as an investor diminished and there was an extraordinary and continued growth in the size and the investment needs of large institutional investors.” U.S. v. Morgan, 118 F. Supp. 621, 647 (S.D.N.Y. 1953).

¹⁰¹ By 1961, institutions owned eighty percent of corporate bonds. SIDNEY ROBBINS, THE SECURITIES MARKETS, OPERATIONS AND ISSUES 216–17 (1966). Individual investors owned ninety percent of all stocks at the beginning of the 1950s. In 1990, institutions would own more than half of all stocks. NEW YORK STOCK EXCHANGE AND WHARTON SCHOOL, THE POLICY IMPLICATIONS OF STOCK OWNERSHIP PATTERNS 1 (1993). At this time, the institutions held thirty-nine percent of all over-the-counter stocks and eighty-seven percent of privately placed securities. OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 6, n.8 (1990) [hereinafter BULLS AND BEARS]. By 1980, institutions were accounting for over seventy percent of New York Stock Exchange volume. Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 114 (1984).

¹⁰² BULLS AND BEARS, *supra* note 101, at 28.

¹⁰³ SOBEL, *supra* note 97, at 221.

¹⁰⁴ See *infra* notes 172–77 and accompanying text.

an underworld of felons to loot publicly traded companies.¹⁰⁵ Boiler rooms were also selling penny stocks in Canadian and other securities.¹⁰⁶ The SEC's presence and requirements for full disclosure did not seem to hamper these schemes greatly.¹⁰⁷

Market problems and scandals required constant amendments to the federal securities laws. For example, amendments were made in 1964 to strengthen financial reporting by public companies.¹⁰⁸ The Williams Act regulated tender offers in 1968, but failed to halt the merger mania of the 1980s and 1990s.¹⁰⁹ The SEC also became a more aggressive agency in the 1960s. Its activist chairman, William Carey, created a new insider trading concept¹¹⁰ that was made up whole cloth under Rule 10b-5.¹¹¹ This position claimed a doctrine of "equal access" to information under Rule 10b-5.¹¹² The Supreme Court later rejected that claim,¹¹³ but

¹⁰⁵ These characters included Lowell Birrell, Ben Cage, Earl Belle, Alexander Guterman, Serge Rubinstein, and Virgil Dardi who collectively destroyed seventy-five large corporations and defrauded investors of \$100 million, at a time when \$100 million was a lot of money. FRANK CORMIER, *WALL STREET'S SHADY SIDE* 146 (1962); T. A. WISE, *THE INSIDERS: A STOCKHOLDER'S GUIDE TO WALL STREET* 120 (1962).

¹⁰⁶ II MARKHAM, *supra* note 67, at 296. Sales of low priced stocks to unsophisticated investors were often conducted through such high-pressure boiler room operations. SELIGMAN, *supra* note 79, at 56-58.

¹⁰⁷ A study by the Attorney General in New York in 1969 found that the disclosure approach to the regulation of new securities issues was proving to be totally ineffective. Insiders were often selling their shares into the market after their company's public issue price had peaked. A REPORT TO THE HONORABLE LOUIS J. LEFKOWITZ, ATTORNEY GENERAL OF THE STATE OF NEW YORK, PURSUANT TO SECTION 352 OF THE GENERAL BUSINESS LAW ON NEW ISSUES OF SECURITIES (Oct. 1969).

¹⁰⁸ 15 U.S.C. § 78m(a) (1994). *See generally* Richard Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706 (describing amendments). Former SEC Chairman William O. Douglas apparently did not believe that insider trading was a crime. In 1953, while serving as a justice on the Supreme Court, Douglas was tipped by his brother on an impending change in control of the Statler Hotel chain, allowing Douglas to make a quick profit of \$8,000 that was then equal to about a third of his annual salary on the Court. BRUCE ALLEN MURPHY, *WILD BILL, THE LIFE AND LEGEND OF WILLIAM O. DOUGLAS* 297 (2003).

¹⁰⁹ Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1994)). For a description of the Williams Act, *see* Miriam P. Hechler, *Toward a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319 (1997).

¹¹⁰ Cady Roberts & Co., 40 S.E.C. 907 (1961).

¹¹¹ 17 C.F.R. § 240.10b-5 (2002).

¹¹² That position was accepted by the Second Circuit in the now famous case of

the SEC continued its aggressive efforts to require equal access to information, culminating in the somewhat ridiculous and infamous Regulation FD.¹¹⁴

Despite the new aggression on the part of the SEC, scandals continued. The 1960s became known as the “go-go” years in the stock markets.¹¹⁵ The decade began with a massive scandal involving specialists on the American Stock Exchange.¹¹⁶ Mutual fund scandals also arrived with the use of “lettered stock.”¹¹⁷

One such scandal of the 1960s was the implosion of Investors Overseas Services (IOS), a giant off-shore mutual fund that had been structured by Edward Cowett, co-author of a leading treatise

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub. nom.*, Coates v. SEC, 394 U.S. 976 (1969).

¹¹³ Chiarella v. U.S., 445 U.S. 222 (1980).

¹¹⁴ Regulation FD stands for “Fair Disclosure” and seeks to prevent selective disclosures to analysts by corporate executives. Selective Disclosures and Insider Trading, Exchange Act Release No. 3442259 (Dec. 20, 1999). The SEC had tried earlier to impose such a requirement under Rule 10b-5 but was slapped down by the Supreme Court. *Dirks v. SEC*, 463 U.S. 646 (1983). Regulation FD seems to be completely at odds with a full disclosure system. Analysts are private sector monitors who have the ability to test company disclosures and make judgments that other investors do not have the time or inclination to make. Denying these individuals access to corporate officials will assure less information to investors, not more. Now, analysts may no longer look behind the numbers presented by management. Their questions and objections may be simply brushed aside by management with a citation to Regulation FD. As one former analyst notes, those companies refusing to deal with analysts in the past simply refused to put out information unless it was good or was done at a time of the company’s own choosing. MURIEL SIEBERT, *CHANGING THE RULES, ADVENTURES OF A WALL STREET MAVERICK* 59 (2002); see also Richard Gibson, *Cozy Analysts? Del Monte’s Flap is the Opposite*, WALL ST. J., Feb. 18, 2003, at C5 (company refuses to answer critical analyst’s question on a Regulation FD conference call). The current nominee for the SEC chairman position had previously called the rule “crazy” but was toning down that comment in his confirmation hearings. Deborah Solomon, *SEC Nominee Urges Curbing States Power*, WALL ST. J., Feb. 6, 2003, at A2. Denied their informational advantage, analysts were left to hype stocks like snake oil in the market run up at the end of the last century, giving rise to more scandal and a \$1.4 billion settlement with regulators. See *infra* notes 210–15 and accompanying text. For a defense of this rule by its principal proponent, see ARTHUR LEVITT, *TAKE ON THE STREET, WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK* (2002).

¹¹⁵ LANGLEY, *supra* note 98, at 18.

¹¹⁶ II MARKHAM, *supra* note 67, at 329.

¹¹⁷ *Id.* at 351–52.

on Blue Sky laws.¹¹⁸ IOS was created to avoid regulation in the United States.¹¹⁹ It was managed by a very colorful character, Bernie Cornfeld, whose loose administration led to sales to U.S. investors, as well as fraud and dubious investments.¹²⁰ That activity gave rise to regulatory action by the SEC, and IOS was crippled. IOS was sold to Robert Vesco, who then proceeded to loot the company of hundreds of millions of dollars. Vesco fled to the Caribbean. He was subsequently jailed in Cuba but remains a fugitive from United States justice.¹²¹

Other scandals of the 1960s included the stock sales of Four Seasons Nursing Centers,¹²² the National Student Marketing Corporation,¹²³ and the pyramid sales scheme of Glenn W. Turner.¹²⁴ All of these investments proved to be disasters for public investors. Full disclosure was doing nothing to stem these frauds.

The SEC stood by helplessly at the end of the "go-go" years in the 1960s¹²⁵ when the securities industry nearly imploded from stock volumes that industry participants were not equipped to handle.¹²⁶ The paperwork crisis created by the rising stock volumes led to account insurance (SIPC) for customers owning

¹¹⁸ LOSS & COWETT, *supra* note 31.

¹¹⁹ CHARLES RAW, ET AL., DO YOU SINCERELY WANT TO BE RICH?: THE FULL STORY OF BERNARD CORNFELD AND IOS (1971).

¹²⁰ *Id.*

¹²¹ ARTHUR HERZOG, VESCO: FROM WALL STREET TO CASTRO'S CUBA, THE RISE, FALL, AND EXILE OF THE KING OF WHITE COLLAR CRIME (1987); Douglas Martin, *Harry L. Sears, 82, Politician and Courier for Vesco Cash*, N.Y. TIMES, May 21, 2002, at B7.

¹²² *In re Four Seasons Sec. Law Litig.*, 58 F.R.D. 19 (W.D. Okla. 1972).

¹²³ The founder of the National Student Marketing Corp., Cortes W. Randell, was convicted for his activities in fraudulently marketing the shares of that corporation. Undeterred, he went on to further securities frauds, for which he was also convicted. *U.S. v. Mumford*, 630 F.2d 1023 (4th Cir. 1980).

¹²⁴ *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

¹²⁵ For a description of the stock market during this period, see BROOKS, *supra* note 99.

¹²⁶ A special study of the securities industry had warned in 1963 that clearing and settlement systems were inadequate to handle large volumes of securities transactions. SECURITIES AND EXCHANGE COMMISSION, SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. Doc. No. 95, pt. 1, at 427 (1963). That warning went unheeded. Volume exploded to 16 million shares, causing the failure of over 100 New York Stock Exchange firms. JAMES E. BUCK, THE NEW YORK STOCK EXCHANGE, THE FIRST 200 YEARS 190 (1992).

securities held by a failed broker-dealer.¹²⁷ This created a new moral hazard, since customers were relieved of the obligation to monitor the financial health of their broker-dealer.¹²⁸ Account insurance also led to more regulation in the form of an incredibly complex set of regulations governing the net capital of broker-dealers¹²⁹ and their treatment of customer funds.¹³⁰ All of these were created in the name of safeguarding the SIPC insurance fund.¹³¹ These regulatory “improvements” did nothing for the market, which was cut nearly in half during the recession that occurred in 1973–1974.¹³²

The paperwork crisis and other problems led to even more restrictive legislation in 1975.¹³³ That legislation regulated clearing and settlement activities, imposed more stringent regulation over broker-dealer operations and sought to create a national “central market” system.¹³⁴ The SEC devised this “central market” system concept as a result of a study it directed of institutional traders.¹³⁵ This scheme posited that investors would be better served by a centralized trading system that would assure that every investor

¹²⁷ The Securities Investors Protection Act of 1970, 15 U.S.C. §§ 78aaa (1994). For a description of the problems that led to the paper work crisis and the creation of SIPC, see SECURITIES AND EXCHANGE COMMISSION, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, REPORT AND RECOMMENDATIONS, H.R. Doc. No. 231, 92d Cong., 1st Sess. (1971).

¹²⁸ The efficiency of government account insurance is highly suspect. A study of bank failures between 1945 and 1994 found that FDIC insurance did not reduce the costs of bank failures and may have actually increased their costs. MELTZER, *supra* note 23, at 434.

¹²⁹ 17 C.F.R. § 240.15c3-1 (2002).

¹³⁰ *Id.* at § 240.15c3-3.

¹³¹ For a description of the SEC’s net capital and customer protection rules, see MARKHAM & HAZEN, *supra* note 49, at chs. 4–5.

¹³² JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970–2001) 26 (2002) [hereinafter III MARKHAM].

¹³³ The Securities Exchange Act of 1934 was extensively amended in 1975.

¹³⁴ For a description of this legislation, see S. Rep. No. 94-75 (1975); H.R. Rep. No. 94-123 (1975).

¹³⁵ Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets (1972). For a description of what the central market envisioned, see SELIGMAN, *supra* note 79, at 499–505.

received the "best" execution price available for orders.¹³⁶ The SEC never was able to articulate exactly how this concept would work in practice, but it was able to convince congress that this should be a national goal.¹³⁷ Although Congress mandated a central market system in 1975,¹³⁸ nothing much ever happened except for some consolidated reporting and a link among exchange specialists.¹³⁹

In seeking centralization, the SEC was actually fighting the market fragmentation being brought about by the bifurcation of institutional and retail traders. In reality, the institutional market proved to be more nimble than the SEC, and it avoided a central market that the SEC could throttle with regulation. The New York Stock Exchange (NYSE) sought its own national market system, *viz.*, a monopoly, by prohibiting its members from executing transaction in listed securities other than on the floor of the NYSE.¹⁴⁰ At the same time, the NYSE was seeking to prevent

¹³⁶ *Id.* at 499.

¹³⁷ *Id.* at 499–500.

¹³⁸ See The Securities and Exchange Act of 1934, 15 U.S.C. § 78k(a)(2) (2000).

¹³⁹ The SEC sought to require a "universal message switch" that would have required customer orders to be routed to the market with the best execution price. See generally BULLS AND BEARS, *supra* note 101, at 47–49 (description of universal message switch and Intermarket Trading System). The SEC was not able to mandate such a system and instead agreed to the creation of the "Intermarket Trading System" under which exchange specialists executed orders at the best price available on any other exchange. *Id.* at 48. This essentially meant that specialists on the regional exchanges would have access to New York Stock Exchange quotes and could key off those quotes instead of competing separately. *Id.*; see generally BULLS AND BEARS, *supra* note 101, at 47–48 (description of universal message switch and Intermarket Trading System); GENERAL ACCOUNTING OFFICE, SEC ACTION NEEDED TO ADDRESS NATIONAL MARKET SYSTEM ISSUES (Mar. 1990) (description of Central Market System issues). Most recently, in 1999, the SEC was again raising the central market concept as electronic communications networks siphoned off business from Nasdaq. Something called the central limit order book was proposed but was not adopted. MARKHAM & HAZEN, *supra* note 49, at § 13. However, the SEC chairman later dropped his support for such a concept. See LEVITT, *supra* note 114, at 191–92, 199 (describing opposition to this proposal).

¹⁴⁰ NYSE Rule 390, later renumbered Rule 394, prohibited off-exchange transactions in its securities by members. The SEC did attack that restriction in 1975 and, after years of wrangling, the NYSE agreed not to apply its provisions to stocks listed after April 26, 1979. BULLS AND BEARS, *supra* note 101, at 48. Some twenty years later, the NYSE dropped that restriction for the grandfathered stocks as well. Michael Schroder, *SEC Clears NYSE to Let Firms Trade Big Board Stocks on Competing*

institutional investors from becoming members so that they could not circumvent existing broker-dealer arrangements.¹⁴¹ Those anti-competitive actions, all sanctioned by the SEC, led to the creation of the “third”¹⁴² and “fourth” markets.¹⁴³ Competition also survived in the form of the Nasdaq market, an electronic quotation facility that was begun in 1968¹⁴⁴ and is now surpassing the NYSE in trading volume.¹⁴⁵

Unfixing commissions in 1975 was a boon to the institutional investor.¹⁴⁶ That action allowed large institutions to exercise their bargaining power and demand nominal commissions. Small investors had no such bargaining power and were left with higher

Markets, WALL ST. J., May 8, 2000, at C21.

¹⁴¹ The SEC aided this effort by passing a rule that required institutional exchange members to send at least eighty percent of their transactions for execution to non-affiliated entities. The SEC asserted that this restriction was needed to assure that institutional exchange members were conducting primarily public securities businesses. H.R. No. 94-123 at 57 (1975).

¹⁴² The third market involved broker-dealers that were not NYSE members conducting transactions in NYSE listed stocks with institutions. Trading in the third market in some stock reached levels as high as twenty-five percent by 1973. CHRIS WELLES, *THE LAST DAYS OF THE CLUB* 53 (1975). The unfixing of commissions undercut the third market substantially. By 1978, third market volume was less than three percent of NYSE volume. LEO M. LOLL & JULIAN G. BUCKLEY, *THE OVER-THE-COUNTER SECURITIES MARKETS* 168 (4th ed. 1981).

¹⁴³ The fourth market involved institutions trading directly with each other without the intermediation of an exchange or broker-dealer. Instinet developed an electronic mechanism for matching such trades. By 1990, Instinet's volume was equal to about thirteen percent of that of the NYSE. BULLS AND BEARS, *supra* note 101, at 19. In 2001, Instinet volumes were reaching 350 million shares a day compared with NYSE volumes of 1.2 billion shares (including institutional as well as retail trades). Compare shares figures at <http://www.institnet.com> (last visited Oct. 26, 2001), with, share figures at <http://www.nyse.com> (last visited Oct. 26, 2001). Instinet, however, was having its own competition problems in 2003. Carlos Grande, *Reuters Chiefs in Drive to Sell Job Cuts Plan: Group to Focus on Market Information*, FIN. TIMES (London), Feb. 19, 2003, at 17.

¹⁴⁴ ROBBINS, *supra* note 101, at 210–11 (1966).

¹⁴⁵ In year-to-date volume up to October 2001, NASD volume exceeded that of the NYSE by about one-third. See <http://www.nasd.com> (last visited Oct. 26, 2001).

¹⁴⁶ Fixed commissions had been a part of the securities industry since the signing of the so-called “buttonwood agreement” in 1792. J. EDWARD MEEKER, *THE WORK OF THE STOCK EXCHANGE* 63 (1930). By the 1970s there were numerous exceptions to the fixed commission rules of the exchanges that were available to institutional investors. In May of 1975, the SEC ordered all commission rates to be unfixed. H.R. Rep. No. 94-123, at 46 (1975).

transactions costs than larger institutions.¹⁴⁷ Of course, small investors could use the services of a discount broker at a lower price, but in so doing they lost access to professional management services and advice.¹⁴⁸ The small investor was also ceding time and place advantages to the institutional investor in any market timing transactions. At the same time, retail investors saw the value of their stocks cut in half as the market plunged during the 1970s.¹⁴⁹

A series of scandals involving "questionable payments" to foreign government officials from off-the-book slush funds of public companies also arose in the 1970s.¹⁵⁰ A long list of public companies made those bribes, but Lockheed was the leader, handing out \$30 million to government officials in Japan, Germany, the Netherlands, Italy, and numerous other countries. Disclosure of those bribes led to the collapse of several governments.¹⁵¹ That scandal resulted in the passage of more full disclosure requirements in the form of the Foreign Corrupt Practices Act of 1977.¹⁵² That legislation prohibited the payment of bribes by foreign issuers.¹⁵³ More importantly, it required public companies to maintain accurate books and records,¹⁵⁴ a requirement that proved to be a myth in the scandals now surfacing.

Scandals involving "bond daddies" in various southern cities¹⁵⁵ and a funding crisis in New York City led to more regulation in

¹⁴⁷ BULLS AND BEARS, *supra* note 101, at 9, n.15.

¹⁴⁸ For a description of the role and duties of discount brokers, see Renee Barnett, Comments, *Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089 (2000).

¹⁴⁹ SELIGMAN, *supra* note 79, at 452.

¹⁵⁰ At the time, there was no United States law prohibiting the bribing of foreign officials, so these were called "questionable Payments."

¹⁵¹ III MARKHAM, *supra* note 132, at 23-24.

¹⁵² Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.).

¹⁵³ 15 U.S.C. § 78dd-1 (2000).

¹⁵⁴ 15 U.S.C. § 78m(b) (2000). A knowing violation of this requirement may be prosecuted criminally. See *id.* § 78m(b)(4)-(5).

¹⁵⁵ Robert Clow, *From Beale Street to Wall Street*, INSTITUTIONAL INVESTOR, June 1997, at 156, 157.

the 1970s.¹⁵⁶ A Municipal Securities Rulemaking Board was created by the 1975 amendments to the federal securities laws as a means to bring full disclosure to municipal securities. That effort, of course, did not prevent further scandals. Unregistered dealers continued their sale of United States government securities utilizing “repos.”¹⁵⁷ The Arthur Andersen & Co. accounting firm was found to have made misrepresentations in accounting statements in connection with the failure of Drysdale Securities Corp., one of the larger of these repo firms. Drysdale was running a Ponzi scheme that cost investors \$300 million.¹⁵⁸ The failure of ESM Government Securities Inc. of Fort Lauderdale, Florida, cost investors another \$300 million and caused a run on deposits of seventy-one Ohio thrifts. “The temporary closing of these financial institutions in turn precipitated a sharp rise in the price of gold and a decline in the value of the dollar.”¹⁵⁹ The failure of

¹⁵⁶ Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427 (1996). There were fiscal problems in New York City, which had more than tripled its budget between 1965 and 1975. The City encountered difficulty in selling one of its bond issues in 1974, and the banks conducting the City’s underwriting had to absorb the balance of the issue. Those banks advised the City that they would no longer take down unsold offerings for their own accounts. The City’s credit was then running out. It could only sell half of a \$900 million issue in 1975. The SEC conducted an investigation of the City’s bond sales and issued a report asserting that the City had misled bond purchasers in failing to disclose the full extent of the City’s financial problems. This report played into the Mayoral race then underway, unseating the incumbent mayor, Abraham D. Beame. In an effort to bail out the City, the New York legislature created the Municipal Assistance Corporation (Big MAC) was created for the purpose of issuing new bonds on the City’s behalf. It too encountered difficulties and was forced to raid State and City pension funds by selling them its bonds. See generally *Tron v. Condello*, 427 F. Supp. 1175 (S.D.N.Y. 1976) (describing MAC and pension raid). The federal government at first refused aid, but after a famous newspaper headline in the New York Daily News (President “Ford to City: Drop Dead”), aid was given. Problems spread to State bonds as well, but recovery was eventually made. III MARKHAM, *supra* note 132, at 48.

¹⁵⁷ The daily trading volume for repo transactions grew to be six times greater than that of the underlying Treasury securities. H.R. Rep. No. 102-722, pt. 1 (1992). For a description of the problems in the repo market, see H.R. Rep. No. 99-258 (1985); S. Rep. No. 99-426 (1986); *Regulating Government Securities Dealers: Hearings before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 99th Cong. 99-38 (June 1985) [hereinafter *Regulating Government Securities Dealers*].

¹⁵⁸ *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987).

¹⁵⁹ H.R. Rep. No. 102-722, pt. 1.

Bevell, Bresler & Schulman Asset Management Corp. caused another \$235 million in losses.¹⁶⁰ A new layer of regulation was added with the enactment of the Government Securities Act of 1986.¹⁶¹

This, once again, did not prevent future problems. A default of a stunning proportions occurred 1982 when the Washington Public Power Supply System (WPPS) defaulted on \$2.25 billion in bonds it had issued to build nuclear power plants.¹⁶² Another massive default occurred in 1994 when Orange County, California announced large losses from speculative trading by its Treasurer. It was the largest municipal bankruptcy in history. Losses amounted to almost \$1,000 for every man, woman, and child in the county.¹⁶³ More problems followed with "pay-to-play" underwriting abuses¹⁶⁴ and "yield burning to avoid IRS restrictions on refunding yields."¹⁶⁵

The savings and loan debacle of the 1980s witnessed the failure of hundreds of those institutions.¹⁶⁶ Many of those S&Ls had been taken over by criminals after regulatory controls first nearly bankrupted those institutions and then opened the door for fraud when changed in a way to encourage fraud by using federal deposit insurance to obtain monies that could be spent on speculative operations, yachts, jets, mansions, expensive art works, and other executive necessities.¹⁶⁷ Most of the larger failed

¹⁶⁰ Regulation of the Government Securities Market, Report by the Securities & Exchange Commission to the House Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce 12 (June 20, 1985).

¹⁶¹ Government Securities Act of 1986, Pub. L. No. 99-571, 100 Stat. 3208 (1986).

¹⁶² *In re Wash. Pub. Power Supply System Sec. Litig.*, 823 F.2d 1349 (9th Cir. 1987).

¹⁶³ FRANK PARTNOY, F.I.A.S.C.O.: BLOOD IN THE WATER ON WALL STREET 94 (1999).

¹⁶⁴ Jon B. Jordan, *The Regulation of "Pay-To-Play" and the Influence of Political Contributions in the Municipal Securities Industry*, 199 COLUM. BUS. L. REV. 489.

¹⁶⁵ See *City of New Orleans v. Smith Barney, Inc.*, 1997 U.S. Dist. LEXIS 6924 (E.D. La. 1999) (describing yield burning).

¹⁶⁶ Over 700 S&Ls failed in a single year (1985). See III MARKHAM, *supra* note 132, at 168 (describing these failures).

¹⁶⁷ The looting was used for such things as a two-week culinary tour of France, a \$148,00 Christmas party, prostitutes, and the services of a number of Senators were purchased (the infamous "Keating Five" that included the now reformist Senator John McCain). Speculative investments included "trash-for-cash," *i.e.*, worthless assets

S&Ls were public companies with audited financial statements.¹⁶⁸ In a passage that would be much quoted in the wake of the Enron and ensuing accounting failures, Federal District Court Judge and former head of the SEC Enforcement Division, Stanley Sporkin, asked in the case of one of the largest of the S&L failures: “where were . . . the accountants and attorneys. . . ? [W]ith all the professional talent involved (both accounting and legal) why [did not] at least one professional . . . [blow] the whistle to stop the overreaching that took place in this case.”¹⁶⁹ Sporkin noted that the head of that S&L had used scores of accountants and lawyers in order to do the “right thing.”¹⁷⁰ Full disclosure failed to prevent this crisis, and accounting firms became the “scapegoats” for that failure.¹⁷¹ They paid \$800 million in fees to defend themselves from suits arising from the S&L crisis in 1992 alone. Ernst & Young paid settlements of \$400 million and Arthur Andersen paid \$79 million in settlements.¹⁷²

bought from the S&Ls own executives, and windmill farms. III MARKHAM, *supra* note 132, at 168–70. Many of these excesses would be repeated in the 1990s bubble right down to the windmill farms that would become a favorite of the Enron Corp. LOREN FOX, ENRON THE RISE AND FALL 131–32, 141 (2003).

¹⁶⁸ The SEC required one S&L entity to restate its financial statements, resulting in the reporting of a \$107 million loss. That restatement was required because the SEC disagreed with the accounting treatment recommended by Arthur Andersen & Co. for certain transactions. A shareholders suit against the accounting firm was dismissed. *In re Fin. Corp. of America S’holders Litig.*, 796 F.2d 1126 (9th Cir. 1986).

¹⁶⁹ *Lincoln Sav. & Loan Ass’n v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990). That language would be used to justify the federal regulation of lawyers after the Enron collapse. Where Were the Lawyers? Behind the Curtain Wearing Their Magic Caps, Hearing on Accountability Issues: Lessons Learned From Enron’s Fall, Testimony of Susan P. Koniak, Professor of Law, Boston University School of Law, Before the Senate Judiciary Comm. (Feb. 2, 2002) (testimony of Susan P. Koniak, Professor of Law, Boston University School of Law).

¹⁷⁰ *Wall*, 743 F. Supp. at 920.

¹⁷¹ Michael M. Neltner, *Government Scapegoating, Duty to Disclose, and the S&L Crisis: Can Lawyers and Accountants Avoid Liability in the Savings and Loan Wilderness?*, 62 U. CIN. L. REV. 655 (1993).

¹⁷² III MARKHAM, *supra* note 132, at 168–70. Lawyers were also targeted as failed policeman and scapegoats. The assets of the law firm of Kaye, Scholer, Fierman, Hays & Handler were seized by the government until that firm agreed to pay out \$41 million in fines. Two other law firms agreed to large settlements: Jones, Day, Reaves and Pogue (\$51 million) and Paul Weiss, Rifkind, Wharton & Garrison (\$40 million). *Id.* at 172; see also *O’Melveny & Myers v. FDIC*, 512 U.S. 79 (1994) (government attack on another law firm).

Banking failures like the Bank of Credit and Commerce International (BCCI) were blamed on the auditors. That bank was later found to be one giant criminal enterprise that bank regulators had permitted to operate globally.¹⁷³ Accountants also failed to unravel the accounting shell game utilized by the Penn Square Bank in Oklahoma to sell \$2.5 billion in loan participations to other banks. The failure of that shopping center bank would cause a national crisis. One victim, the giant Continental Bank in Chicago, which had its own auditors examine the Penn Square loans would have to be nationalized by the government.¹⁷⁴

Full disclosure looked even more like a bad joke with the insider trading scandals of the 1980s that involved the likes of Ivan Boesky.¹⁷⁵ Sanctions were later strengthened after a series of scandals, but insider trading continues.¹⁷⁶ Investors poured \$10 billion into penny stocks.¹⁷⁷ Hundreds of thousands of those investors were then thoroughly swindled by the likes of Blinder Robinson and First Jersey Securities.¹⁷⁸ Additional legislation was

¹⁷³ PETER TRUELL & LARRY GURWIN, *FALSE PROFITS: THE INSIDE STORY OF BCCI, THE WORLD'S MOST CORRUPT FINANCIAL EMPIRE* 315 (1992).

¹⁷⁴ PHILLIP L. ZWEIG, *BELLY UP: THE COLLAPSE OF THE PENN SQUARE BANK* 247 (1985).

¹⁷⁵ For a description of those scandals, see DAVID A. VISE & STEVE COLL, *EAGLE ON THE STREET* (1991). A chilling side note to these scandals was the plea bargaining by Ivan Boesky and the unpopularity of junk bonds and related merger activity that launched the SEC and the U.S. Attorney's Office in New York on a vendetta against Michael Milken and Drexel Burnham Lambert, sending him to prison with a record fine and destroying the firm. See III MARKHAM, *supra* note 132, at 126 (describing this prosecution); JESSE KORNBLUTH, *HIGHLY CONFIDENT: THE CRIME AND PUNISHMENT OF MICHAEL MILKEN* (1992). Other claimed excesses of this era were the junk bonds used to finance the merger mania then occurring. For an attack on Milken and the junk bond market, see CONNIE BRUCK, *THE PREDATOR'S BALL: THE JUNK-BOND RAIDERS AND THE MAN WHO STAKED THEM* (1988). For criticism of leveraged buyouts use to fund acquisitions, see GEORGE ANDERS, *MERCHANTS OF DEBT, KKR AND THE MORTGAGING OF AMERICAN BUSINESS* (1992); BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE, THE FALL OF RJR NABISCO* (1990).

¹⁷⁶ See Insider Trading Sanctions Act of 1984, 15 U.S.C. § 78u(d) (2000); Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. §§ 78t-1, 78u-1 (2000).

¹⁷⁷ Joseph I. Goldstein & L. Delane Cox, *Penny Stock Markups and Markdowns*, 85 Nw. L. Rev. 676 (1991).

¹⁷⁸ Some of these schemes, such as the blind pools, were apparently borrowed from the South Sea Bubble in the 1720s. III MARKHAM, *supra* note 132, at 148-149.

enacted to deal with those penny stock frauds,¹⁷⁹ but they would be succeeded with but little interruption by the “microcap” pump and dump schemes of the 1990s.¹⁸⁰

The stock market crash of 1987, however, proved once again that the SEC and full disclosure do not stabilize a market or prevent precipitous declines; economics is responsible for those tasks. The 1987 decline set a new record for the most severe one-week decline in history, exceeding that of the 1929 crash.¹⁸¹ The SEC blamed that event on the speculative excesses of commodity futures traders operating on low margins in stock index futures contracts.¹⁸² The commodity futures markets, however, according to the SEC’s own reports, had become “synthetic” stock markets and were being used to price stocks.¹⁸³ In other words, the commodity markets were viewed to be more efficient than the stock markets. How could this be possible when there was no full disclosure concept in the commodity markets?¹⁸⁴

The intrusive SEC regulatory structure periodically caused complaint and some half-hearted efforts were made to ease that burden. Securities litigation had become an industry into itself. Battalions of lawyers were filing suit immediately after any dip in the price of a public security. Settlements were extorted from those companies that provided little benefit to shareholders, but

¹⁷⁹ Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931.

¹⁸⁰ To cite a few examples: The SEC sued eighty-two defendants in August of 1999 for microcap fraud. Another eighty-five were indicted for manipulating stock prices in 1996. The A.S. Goldman firm was defrauding investors of \$100 million, and Duke & Co. was another fraudulent operation. III MARKHAM, *supra* note 132, at 343. One federal undercover operation resulted in the arrest of 120 individuals involved in a pump and dump scheme. Kara Scannell, *Wolfson is Convicted in “Pump and Dump” Penny-Stock Scheme*, WALL ST. J., Mar. 28, 2003, at C1.

¹⁸¹ Jerry W. Markham and Rita Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L. J. 1993 (1988).

¹⁸² *Id.* at 2011.

¹⁸³ SEC. AND EXCH. COMM’N DIV. OF MKT. REGULATION, THE OCTOBER 1987 MARKET BREAK, 3-6, 3-7, 3-8 (1988).

¹⁸⁴ The Commodity Futures Trading Commission, the federal agency charged with regulating the commodity futures industry, had rejected such a concept early in its history. Commodity Futures Trading Commission, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material Non-Public Information* (Sept. 1986).

paid large sums to the lawyers. Abuses in litigation included the use of "professional plaintiffs" to bring class action lawsuits.¹⁸⁵ The Private Securities Litigation Reform Act of 1995¹⁸⁶ and the Securities Litigation Uniform Standards Act of 1998¹⁸⁷ sought to restrict over-reaching by lawyers in those private actions. Critics claim that reform efforts to curb abusive litigation have had little effect.¹⁸⁸ Indeed, the number of securities related lawsuits more than doubled in 2001 over the prior year.¹⁸⁹

The Market Bubble

The Run Up

The SEC had not stopped fraud, scandals, and market failures during its tenure. That might be forgiven as an impossible task. The real stress test was whether it would prevent the excesses that would lead to a bubble such as that in the 1920s. The SEC failed that measure miserably. The market run up at the end of the century had many eerie similarities to that of 1929.¹⁹⁰ Even

¹⁸⁵ Jordan Eth & Daniel Drosman, *The Private Securities Litigation Reform Act: Five Years Young*, 34 SEC. & COMM. REG. REP. 153, 157 (July 2001).

¹⁸⁶ The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737.

¹⁸⁷ Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 327.

¹⁸⁸ *Id. Compare with, Common Sense Legal Reform Act*, Hearings Before the Subcommittee on Telecommunications and Finance of the House Committee on Commerce, 104th Cong., 1st Sess. 73-86 (1995) (statistics suggesting that there was no inordinate increase in the number of class action lawsuits involving securities claims).

¹⁸⁹ *What's News*, WALL ST. J., June 10, 2002, at A1. Most securities customers were relegated to arbitration proceedings where their claims involved a broker-dealer. Despite intensive regulation by the SEC of those broker-dealers and an incredibly complex net capital rule, a General Accounting Office Study found that more than one-half of NASD arbitration awards were uncollectible. Marilyn Blumberg Cane & Marc J. Greenspan, *Securities Arbitration: Bankrupt, Bothered and Bewildered*, 7 STAN. J. L. BUS. & FIN. 131, 136 (2002) (describing GAO findings).

¹⁹⁰ The 1990s was said to be one of history's "euphoric speculative bubbles." E.S. Browning, *Greenspan Warns of Bubble, and Markets Keep Rising*, WALL ST. J., Jan. 17, 2000, at C1; *Trapped by the Bubble*, THE ECONOMIST, Sept. 25, 1999, at 17. For a description of the market bubble in the 1920s, see KLEIN, *supra* note 21. Federal Reserve Chairman Alan Greenspan had claimed for a number of years that a bubble was underway, using the famous descriptive term "irrational exuberance." III MARKHAM, *supra* note 132, at 315.

Federal Reserve Chairman Greenspan's blundering efforts to squelch the market by ratcheting up interest rates smacked of past errors forgotten.¹⁹¹ Of course one should probably ask exactly what is wrong with a market bubble before trying to squelch it at all costs. The market rise in the 1920s was a reflection of a revolution in communications and transportation. The radio, motion pictures, and automobiles spurred the economy to new heights and changed lives forever.¹⁹² In the 1990s, the computer and the Internet revolutionized society in ways that are too numerous to even catalogue.¹⁹³ Why anyone would want to curb those advances escapes at least this casual observer.

The stock market mania in the 1920s that was induced by the advances of that period did result in problems with speculators who were overextended and trading on margin.¹⁹⁴ The Securities Exchange Act of 1934 was adopted to prevent that problem from

¹⁹¹ The Federal Reserve Board had kept interest rates low during the 1920s in order to assist England in returning to the gold standard. Then when the market appeared overheated, the Fed ratcheted up rates. II MARKHAM, *supra* note 67, at 150–53. Fed Chairman Alan Greenspan led an effort to stop the market bubble by several rapid and crippling interest rate increases. That worked, and the bull market turned into a disaster for investors. Greenspan then reversed himself by dropping rates to the lowest level in decades, but it was too late, the damage had been done. III MARKHAM, *supra* note 132, at 349–353; see also Peter G. Gosselin, *Greenspan Legacy is Wobbling*, L.A. TIMES, July 8, 2001, at A1 (describing actions of Federal Reserve Board); Lawrence Kudlow, *Golden Years?*, WALL ST. J., Feb. 26, 2003, at A16 (Greenspan's efforts to smash the stock market and curb inflation now threaten the economy with deflation.).

¹⁹² The stock of the RCA company was a particular target of speculators and manipulative pools. That company, however, was truly a speculative opportunity. It was not smoke and bubbles. The industry saw radio sales increase by 2000,000 units between 1928 and 1929. RCA saw sales of \$176 million in 1929 with profits approaching \$16 million, a tidy sum in those days. II MARKHAM, *supra* note 67, at 150. The airplane industry was also getting off the ground, so to speak, during this era.

¹⁹³ Shopping online, online banking and trading, instant communications with Blackberries and cell phones, word processing, and B2B connections have changed the daily lives of nearly everyone. By the end of the last century more than half of all Americans had a computer in their homes, and Americans were spending more on computers than televisions. III MARKHAM, *supra* note 132, at 289. More than half the United States was using the Web by the beginning of 2002. *What's News*, WALL ST. J., Feb. 4, 2002, at A1.

¹⁹⁴ For a description of the concerns raised by margin in the securities industry, see MARKHAM & HAZEN, *supra* note 49, at §8:2. Interestingly, the Federal Reserve Board subsequently concluded that margin regulation should not be viewed as a significant part of the federal regulatory structure. Nevertheless, little was done to remove those controls. *Id.* at §8:3.

occurring in the future.¹⁹⁵ Margin trading, however, would be resurrected by customers at day trading shops in the 1990s. At one point there were 400,000 day-traders.¹⁹⁶ That was a large number, but it was one that was outmatched by the margin accounts of the 1920s.¹⁹⁷ Nevertheless, this speculation raised regulatory alarms.¹⁹⁸

The initial public offerings (IPOs) of the dotcom companies at the end of the last century were reflective of the excesses of the 1920s. These highly speculative Internet operations became "hot issues," which quickly traded in multiples of their offering price.¹⁹⁹ Many of those enterprises just as quickly crashed. For example, the price of Scient rose from \$10 to \$133 before falling to \$1.81.²⁰⁰

¹⁹⁵ See Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMPLE L. REV. 59, 101 (1991) (describing federal margin regulation of securities and comparing it with the absence of regulation in the commodity futures industry).

¹⁹⁶ The day traders usually found themselves on the losing end of a large number of trades, often conducted on margin. Ruth Simon, *Day-Trading Firms' Moves that Skirt Margin Lending Rules are Being Probed*, WALL ST. J., June 23, 1999, at C1; Edward Wyatt, *Day Traders are Formidable Market Force*, N.Y. TIMES, Apr. 14, 1999, at C1. Most day traders lost money. Michael Schroeder, *Day-trading Firms Rebuked by Group of State Regulators Over Marketing*, WALL ST. J., Aug. 10, 1999, at A26; Rebecca Buckman, *Report on Day-Trading Firm's Accounts Finds Nearly Three-Fourths in the Red*, WALL ST. J., Aug. 9, 1999, at C15. The NASD and the NYSE adopted special margin requirements and risk disclosures for day traders and retail customers. Securities Exchange Act Release No. 44009, 2001 WL 197851 (Feb. 27, 2001); Securities Exchange Act Release No. 44223, 2001 WL 431540 (Apr. 26, 2001). The SEC also charged some large day trading firms with manipulating stocks on the Nasdaq market. Susanne Craig, *Several Pioneers of Day Trading to Pay Big Fines*, WALL ST. J., Jan. 15, 2003, at C1. The number of day traders was shrinking in 2002. Aaron Elstein, *Yes, Day Traders Still Exist, They Just Keep a Lower Profile*, WALL ST. J., Oct. 17, 2002, at D4.

¹⁹⁷ There were about 600,000 accounts trading on margin in 1929 or about forty percent of brokerage accounts. II MARKHAM, *supra* note 67, at 150. The number of margin accounts today is uncertain, but the widely popular cash management account created by Merrill Lynch and widely copied by other institutions has a margin feature that allows investors to use their accounts as margin accounts that create a secured line of credit. *Id.* at 7.

¹⁹⁸ As if he were, indeed, an old actor in an even older movie, Alan Greenspan expressed concern during the market bubble of the 1990s that margin trading might be contributing to speculative excesses. III MARKHAM, *supra* note 132, at 350.

¹⁹⁹ See generally JOHN CASSIDY, *DOT.CON, THE GREATEST STORY EVER SOLD* 29 (2002).

²⁰⁰ Leah Beth Ward, *E-Consulting Firms Sinking in Shakeout; Privately Held Area Companies Fare Better*, DALLAS MORNING NEWS, Jan. 6, 2001, at F1. Red Hat rose by \$100 to \$151 before dropping to \$5.22. Joseph Menn, *Linux Firms Still Searching for*

Priceline.com stock fell from \$162 to \$1.12.²⁰¹ Yahoo stock dropped ninety-two percent.²⁰² Stock values at Cisco Systems were reduced by \$148 billion.²⁰³ Other big losers were EMC Networks, Oracle, Nortel Networks, Merck, and General Electric.²⁰⁴ Nasdaq stocks lost seventy percent of their value, and hundreds of companies were dropped from trading in that market following the collapse of market prices in 2000.²⁰⁵ Estimates have ranged as high as \$8.5 trillion as to the market value lost on the Nasdaq during the market reverse that began in 2000.²⁰⁶

Some comparable figures are available from 1929. Stocks listed on the NYSE dropped in value from \$90 billion to \$16 billion, a drop of over eighty percent.²⁰⁷ The investment trusts of that era were closed end funds that owned many speculative securities.²⁰⁸ The fall in their share prices would have done a dotcom company proud. For example, the Goldman Sachs Trading Corporation saw its share prices fall from \$326 to \$1.75.²⁰⁹ The Blue Ridge Corp. stock price went from \$100 to \$3, and the American Founders Corp. shares dropped from \$30 to 38 cents.²¹⁰

Scandals

The stock analyst scandals that followed the market collapse in this century had overtones of abuses from the 1920s.²¹¹ Harry

Success, L.A. TIMES, Oct. 2, 2000, at C1.

²⁰¹ Steven Syre & Charles Stein, *Boston Capital: Net Findings: Travel Works, Groceries Don't*, BOSTON GLOBE, July 11, 2001, at C6.

²⁰² *Year in Life of Richard Li*, SOUTH CHINA MORNING POST (LEXIS), Aug. 17, 2001, at A1.

²⁰³ Floyd Norris, *After Two-year Drop In Markets, Calendar Turns on Note of Hope*, N.Y. TIMES, Jan. 1, 2002, at A1.

²⁰⁴ *Id.*

²⁰⁵ Vincent Boland, *Nasdaq Changes 15 Stocks*, FIN. TIMES (LONDON), Dec. 16, 2002, at 26.

²⁰⁶ *Cutting Interest Rates Won't Halt Deflation*, POST-DISPATCH, Nov. 5, 2002, at B6.

²⁰⁷ II MARKHAM, *supra* note 67, at 155.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ See generally Burton G. Malkiel, *The Great Wall Street*, WALL ST. J., Oct. 14, 2002, at A16 (describing analysts' conflicts now existing on Wall Street).

Blodget, an analyst at Merrill Lynch, described one stock he had publicly praised as a "piece of junk" in an internal email.²¹² After the New York Attorney General, Eliot Spitzer, conducted an investigation of Blodget that revealed conflicts of interest in Merrill Lynch's research department, it agreed to pay \$100 million in fines to the State of New York.²¹³ Internal emails had shown that firm analysts were privately disparaging company stocks, calling some "crap" while publicly recommending those shares.²¹⁴ Mary Meeker, an analyst at Morgan Stanley, was given the title of "queen of the net" for hyping IPO internet stock offerings that her firm was underwriting.²¹⁵ The State of Massachusetts claimed that analysts employed at Credit Suisse First Boston were touting stocks that they were privately disparaging in order to obtain investment banking business.²¹⁶ Jack Grubman, an analyst at Salomon Smith Barney, was alleged to have pumped telecommunications stocks so that his firm could obtain their underwriting business.²¹⁷ Even juicier was the charge that Grubman had been induced to upgrade his rating on AT&T by Sandy Weill, the head of Citigroup, in order to please that client.²¹⁸

The National Securities Markets Improvement Act of 1996 had

²¹² Patrick McGeehan, *E-Mail Gaps May Mean Fines for Big Firms*, N.Y. TIMES, Aug. 2, 2002, at C4.

²¹³ *Id.*

²¹⁴ Joshua Chaffin & Gary Silverman, *Merrill Escapes Severe Penalty*, FIN. TIMES (LONDON), May 22, 2002, at 1.

²¹⁵ CASSIDY, *supra* note 199, at 206-17.

²¹⁶ Susanne Craig, *Massachusetts Claims CSFB Stock Reports Led Investors Astray*, WALL ST. J., Oct. 22, 2002, at C1.

²¹⁷ See generally Randall Smith & Susanne Craig, *Will Grubman Case Tone Down the Exaggeration by Analysts?*, WALL ST. J., Sept. 24, 2002, at C1; Charles Gasparino, *Salomon's Grubman Resigns: NASD Finds "Spinning" at Firm*, WALL ST. J., Aug. 16, 2002, at A1; Charles Gasparino, *Salomon Agrees to Settle Stock-Hype Case*, WALL ST. J., Sept. 24, 2002, at C1.

²¹⁸ Allegedly, Citigroup made a \$1 million donation to a preschool (92nd Street Y) in order to assist Grubman's children obtaining entrance into that elite school. Grubman later claimed that he had made the story up and that the donation was not for the purpose of having him report favorably on AT&T. Emily Nelson & Laurie P. Cohen, *Why Jack Grubman Was So Keen to Get His Twins into the Y*, WALL ST. J., Nov. 15, 2002, at A1. Regulators decided not to charge Weill, but Grubman was barred from the securities industry and fined \$15 million. *Money & Business; Rogues of the Year*, U.S. NEWS & WORLD REPORT, Dec. 30, 2002, at 33.

sought to preempt much state securities regulation,²¹⁹ but state attorney generals were simply ignoring that statute.²²⁰ Indeed, they have taken over much of the regulation of securities, further marginalizing the SEC. A wolf pack of forty state regulators began a joint investigation of the malpractices of stock analysts and of their recommendations of stocks for IPOs that were being underwritten by their firms.²²¹ This resulted in a spectacular \$1.4 billion joint settlement with several large investment banks.²²² Among other things, the settlement sought to require those firms to fund “independent” research for their customers, whatever that might mean.²²³ Citigroup alone paid \$450 million of the \$1.4 billion industry settlement.²²⁴

It is unclear, however, what laws were broken and whether the

²¹⁹ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416.

²²⁰ The attorney general wolf packs have actually taken over much regulation of the securities industry in the aftermath of the Enron scandal. Jerry W. Markham, *Super-Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, Great Britain and Japan*, 28 BROOK. J. INT'L L. – (forthcoming 2003). Even before the bubble burst, Eliot Spitzer's predecessor as the New York Attorney General had been conducting investigations of microcap fraud. State securities administrators also brought over 100 enforcement actions in July of 1998 in a coordinated effort to stop market fraud. III MARKHAM, *supra* note 132, at 260–61.

²²¹ Michael Schroeder, *States' Wall Street Probes Bog Down*, WALL ST. J., Sept. 13, 2002, at C5. Analysts conflicts had been of concern after the stock market crash of 1929. Section 17(b) of the Securities Act of 1933, 15 U.S.C. § 77q(b) was enacted to preclude secret compensation or benefits from issuers to analysts in order to induce them to tout the issuer's stock. This did not remove analysts' conflicts. Rather, a market solution appeared in the form of the discount broker. Charles Schwab built one of the largest broker-dealer firms in the country on the basis of his claims that research in the full service firms was conflicted and did not justify the higher commissions charged by those firms employing analysts. Charles Schwab & Co., however, later found it necessary to provide advice to customers. JOHN KADOR, CHARLES SCHWAB, HOW ONE COMPANY BEAT WALL STREET AND REINVENTED THE BROKERAGE INDUSTRY, 23–24, 98 (2002); see also BENJAMIN COLE, THE PIED PIPERS OF WALL STREET: HOW ANALYSTS SELL YOU DOWN THE RIVER (2001) (describing analysts' shortcomings).

²²² This was a joint settlement with state and federal securities regulators, leading to strife and competition for the headlines. See generally Charles Gasparino, *Analyst Pact is Held up by Words*, WALL ST. J., Jan. 16, 2003, at C1 (describing tiff over language in settlement report). Other firms joined in the settlement. *Piper Jaffray Joins Settlement; to Pay \$25M, Make Changes*, 35 SEC. & COMM. REG. REP. 1, 11 (Jan. 6, 2003).

²²³ Randall Smith, *Regulators Set Accord With Securities Firms, But Some Issues Persist*, WALL ST. J., December 23, 2002, at C1.

²²⁴ *Id.*

settlement provided anything of value to the market.²²⁵ In any event, these were the same conflicts and abuses that were at the heart of the scandals that followed the stock market crash of 1929. Congressional hearings that led to the adoption of the federal securities laws revealed that investment counselors were being paid to tout stocks and newspaper reporters were bribed to carry favorable reports on particular stocks.²²⁶

Share "spinning" schemes in the 1990s looked strangely like the preferred lists used by J.P. Morgan in the 1920s.²²⁷ Goldman Sachs was under scrutiny by congressional investigators after it was disclosed that executives of twenty-one large U.S. companies had received shares in IPO hot issues from Goldman Sachs Group.²²⁸ Those shares were allocated in order to induce those executives to send their firms' business to Goldman.²²⁹ Frank

²²⁵ See generally Roy Smith, *Attacking Wall Street With a Blunt Instrument*, FIN. TIMES (London), Jan. 7, 2003, at 13 (criticizing the settlement).

²²⁶ II MARKHAM, *supra* note 67, at 144.

²²⁷ *Id.* at 145–56. The practice of "spinning" involves the allocation by investment bankers of shares in hot IPOs to officers of clients in order to gain their underwriting business. See generally Randall Smith & Susan Pulliam, *Buddy System, How a Technology-Banking Star Doled Out Shares of Hot IPOs*, WALL ST. J., Sept. 23, 2002, at A1 (describing these transactions). J.P. Morgan and other investment bankers used "preferred lists" in the 1920s to allocate hot issues to clients, friends, and persons of influence. Those practices were condemned at length in the hearings that led to the enactment of the federal securities laws. II MARKHAM, *supra* note 67, at 145–56.

²²⁸ Randall Smith, *Goldman Gave Hot IPO Shares to Top Executives of its Clients*, WALL ST. J., Oct. 3, 2002, at A1. The SEC had been investigating such practices since at least 1997. Michael Siconolfi, *SEC, NASD Begin Probes of IPO 'Spin' Accounts*, WALL ST. J., Nov. 13, 1997, at A3.

²²⁹ *Id.* The government had attacked the underwriting process for securities in the 1950s. *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953). Seeking to require competitive bidding for shares, the Justice Department charged several leading underwriters with monopoly practices. *Id.* Federal District Court Judge Harold Medina threw that case out of court. *Id.* The bursting of the bubble on Wall Street at the end of the century opened the door for renewed government attacks, including investigations of "laddering," i.e., IPO allocations conditioned on the purchase of additional shares in the after market. See, e.g., Randall Smith, *IPO 'Laddering' Case Expands*, WALL ST. J., Feb. 26, 2003, at C1. A district court denied motions to dismiss claims against underwriters for more than 300 IPOs. *In re Initial Pub. Offering Sec. Litig.*, 21 MC 92 (SAS), 2003 U.S. Dist. LEXIS 2373 (S.D.N.Y. Feb. 19, 2003). The plaintiffs charged that the defendants manipulated those underwritings by requiring additional purchases in the aftermarket for those given IPO allocations and by requiring a payment of profits for sales into the aftermarket. *Id.*

Quattrone at Credit Suisse First Boston allocated IPOs to private clients valued at over \$200 million, making them profits on average of \$1 million each.²³⁰ Sales by insiders of the stocks of their companies in recent years, even while those securities were being touted to the public, mock similar sales by corporate titans of yesteryear.²³¹

The collapse of the Enron Corp. and the bankruptcy of WorldCom, Inc. had their match in the 1930s with the failure of the Insull empire of holding companies, the massive fraud by Ivar Kruger at the Swedish Match Company and the fall of the Alleghany Corp. that had been put together by the Van Sweringen brothers.²³² Thoughtful individuals viewing this history might want to ask what exactly federal regulation of securities has accomplished and at what cost to those being regulated, as well as to those who mistakenly thought they were given some measure of protection by the SEC's system of full disclosure.

Market touts flourished on the Internet, but their pump and dump schemes varied little from those of the unregulated markets of the 1920s. One needs only have read the daily business news to find an announcement that the government was prosecuting yet another stock swindle during the market run up in the 1990s.²³³ Usually, small, unsophisticated customers were the victims of

²³⁰ Robert Clow & Scott Morrison, *'Frank's friends' made up to \$400m*, FIN. TIMES, March 15–16, 2003, at 17.

²³¹ Daniel Altman, *When Insider's Sales are a Long-Term Plan*, N.Y. TIMES, May 19, 2002, § 3, at 1. Ken Lay, the head of the Enron Corp., was selling millions of dollars of the company's stock even while he was urging employees to load up on that stock. *Id.* Section 16 of the Securities Exchange Act of 1934 (15 U.S.C. § 78p) was adopted after it was discovered that Albert Wiggin, the head of the Chase National Bank, had been selling that bank's stock short even while it was being sold to investors through a bank affiliate. II MARKHAM, *supra* note 67, at 204. In another throwback to the days of Wiggin, Samuel Waksal, the indicted insider trader in the Martha Stewart scandal and former head of ImClone Systems, Inc. bought put options on his company's stock before negative announcements, allowing him to make profits. Kara Scannell, *Waksal Made Money Betting Against ImClone*, WALL ST. J., Mar. 12, 2003, at C1.

²³² II MARKHAM, *supra* note 67, at 175–76.

²³³ David Barboza, et al., *Penny Stock Fraud is Billion-Dollar Game*, N.Y. TIMES, Nov. 19, 1999, at A1. High pressure, "boiler room" sales operations, Ponzi schemes and manipulations were endemic in the 1990s. *Id.* Between 1996 and 1998, over 1,000 telemarketers were charged with fraud in their sales operations. *What's News-World Wide*, WALL ST. J., Dec. 18, 1998, at A1. Microcap fraud was amounting to \$2 billion a year. Barboza, *supra*, at A1.

those frauds.²³⁴ They were fleeced for billions of dollars.²³⁵ Indeed, state securities administrator's estimated that securities fraud was costing investors in the United States some \$1 million per hour.²³⁶ This number bears comparison to the \$25 billion in worthless securities sold to investors in the 1920s.²³⁷

Insider trading continued. The former chairman of Cendant was indicted for selling \$11 million of that company's stock just before its announcement of massive accounting irregularities.²³⁸ Dr. Samuel Waksall, the founder of ImClone, was arrested on June 12, 2002 and charged with insider trading in the stock of his company.²³⁹ The doctor sold stock after he learned that the Food and Drug Administration had refused to review an application for a cancer drug of ImClone.²⁴⁰ Martha Stewart, the house and garden doyenne, was also being investigated because she had sold stock in ImClone and was a friend of Waksall.²⁴¹ Martha Stewart's Company, Martha Stewart Living Omnimedia, Inc., saw its share price fall when news of Martha's Stewart's sale was announced. Stewart's broker's assistant pled guilty to charges for his role in this affair.²⁴²

A porno film actress pled guilty to insider trading.²⁴³ The actress, Kathryn Gannon, who used the stage name of Marilyn Starr, had been tipped by James J. McDermott, Jr., the former head of Keefe, Bryette & Woods.²⁴⁴ He also pled guilty to securities

²³⁴ See, e.g., Evan Perez, *Drive is Launched on Investment Fraud Targeting Florida's Retirees, Foreigners*, WALL ST. J., Jan. 12, 2001, at C16. One enforcement sweep involved investment schemes directed at elderly investors. *Id.*

²³⁵ SIEBERT, *supra* note 114, at 191.

²³⁶ *Id.*

²³⁷ II MARKHAM, *supra* note 67, at 179.

²³⁸ *Former Official Allegedly Sold Stock Shortly Before Cendant Fraud Unveiled*, 34 SEC. REG. & L. REP. 1994 (2002), available at <http://subscript.bna.com/samples/cad.nsf/cbeebd717c2395bb85256b5200778094/83d140f5c073aaa085256c98005acf5c?OpenDocument>.

²³⁹ Geeta Anand et al., *Biotech Bust, ImClone's Ex-CEO Arrested, Charged with Insider Trading*, WALL ST. J., June 13, 2002, at A1.

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ *Guilty Plea in Stock-Tip Case*, N.Y. TIMES, June 12, 2002, at C10.

²⁴⁴ *Id.*

fraud.²⁴⁵ An individual pleaded guilty to insider trading through tips that he obtained from a postal service employee.²⁴⁶ The postal service employee was telephoning him information from the column "Inside Wall Street" in *Business Week*.²⁴⁷ The postal service employee would read him the column when the magazine reached the facility in advance of being distributed to the public.²⁴⁸ The SEC's full disclosure and equal access to information regime was proving to be porous indeed.

Internet fraud was another growth area.²⁴⁹ The SEC assigned 200 lawyers to a cyber task force to police the Internet and dozens of cases were brought against those committing fraud.²⁵⁰ But fraud continued and was working its way down into the high schools.²⁵¹ A seventeen year old student, Benjamin Snyder, was charged by the SEC with planting false new stories on the Internet where he posted price of a stock.²⁵² He was not the youngest offender. Jonathan Lebed of Cedar Grove, New Jersey, was sued by the SEC when he was fifteen.²⁵³ That youngster had to repay \$285,000 of gains.²⁵⁴ In another case, the SEC charged some Georgetown law students and one of their mothers with committing securities fraud on the Internet.²⁵⁵

Market integrity was in question. The SEC's "Large Firm Project" found that twenty-five percent of broker-dealer branch office examinations resulted in referrals for enforcement action.²⁵⁶

²⁴⁵ *Id.*

²⁴⁶ *Guilty Plea in Postal Case*, WALL ST. J., Oct. 11, 2002, at C7.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ See e.g. Alex Berenson, *2 Accused of Using E-Mail to Commit Stock Fraud*, N.Y. TIMES, Feb. 25, 2000, at C2. Crime on the Internet was estimated at \$266 million annually at the end of the century. Magia Pesola & Louise Kehoe, *Cybercrime in US Soars to Dollars 266m*, FIN. TIMES, Mar. 23, 2000, at World News: U.S. & Canada, 4, available at LEXIS, News Library, FIN. TIMES File.

²⁵⁰ II MARKHAM, *supra* note 67, at 259–61, 293–94, 344–45.

²⁵¹ Judith Burns, *Teen Settles Matter with SEC of Scheme to Raise Stock Price*, WALL ST. J., June 26, 2002, at C3.

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ III MARKHAM, *supra* note 132, at 345.

²⁵⁶ Books and Records Requirements for Brokers and Dealers Under the Securities

State regulators found that customers were being defrauded of billions of dollars each year as the result of sales practice violations by broker-dealers, all of whom were subject to elaborate regulation under the federal securities laws.²⁵⁷ Robert Morgenthau, the district attorney in Manhattan, used the Martin Act to prosecute pump-and-dump and other Internet dotcom stock trading scandals.²⁵⁸ The *Wall Street Journal* was periodically publishing the names of hundreds of individuals and firms being disciplined by the New York Stock Exchange and the Nasdaq.²⁵⁹ Despite this incredible list of violators, those institutions were themselves criticized for failing to police their markets.²⁶⁰ Nasdaq market makers were accused of colluding with each other to make non-competitive quotes.²⁶¹ Eight floor brokers on the NYSE were charged with criminal violations for front running customer orders.²⁶²

These problems all occurred under a vigilant and aggressive SEC that had been administering a complete and complex set of regulations mandating full disclosure.²⁶³ An activist and very pro-regulation chairman guided that agency during the height of the market run up, under a decidedly pro-regulation administration.²⁶⁴

Exchange Act of 1934, 66 Fed. Reg. 55818, 55828 (Nov. 2, 2001) (codified as amended at 17 CFR pts. 240 and 242).

²⁵⁷ *Id.*

²⁵⁸ Jerry Markon & Charles Gasparino, *For Corporate-Crime Fighters, No Law is Old*, WALL ST. J., Oct. 2, 2002, at C1.

²⁵⁹ See, e.g., Cary Szafranski, *NYSE Regulators Discipline Companies, People*, WALL ST. J., Dec. 17, 2001, at B7H.

²⁶⁰ Order Instituting Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Findings of the Commission, Exchange Act Release No. 34-40900 (Jan. 11, 1999), available at <http://www.sec.gov/litigation/admin/34-40900.txt> (on file with North Carolina Journal of International Law and Commercial Regulation).

²⁶¹ *Id.*

²⁶² MARKHAM, *supra* note 67, at 261–62. Another front running scandal broke out on the Exchange floor in April 2003. Kate Kelly & Susanne Craig, *Big Board is Probing Specialists for Possible 'Front-Running'*, WALL ST. J., April 17, 2003, at A1.

²⁶³ LEVITT *supra* note 114.

²⁶⁴ See generally LEVITT, *supra* note 114. The chairman wrote a book defending himself. *Id.* He blamed Enron and other accounting scandals on industry lobbying, Republicans, and “New Democrats” who blocked even more intrusive regulation he favored. *Id.*

Full disclosure did not prevent the bubble or the ensuing scandals. Indeed, the Enron and telecom implosions that grew from the accounting fraud on that chairman's watch were nurtured by the full disclosure environment he was so vigorously advocating and expanding. Investors were led to believe, falsely, that they were protected by, and assured of, full disclosure under the federal securities laws. They received no such thing. To the contrary, they were simply cheated by their government's totally unrealistic and false promises of such protection.

Accountants as Policeman

An early SEC chairman, William O. Douglas, New Dealer and future Supreme Court justice, declared that the SEC should be "the pace setter in the accounting field."²⁶⁵ Full disclosure under the federal securities laws hinges on the accuracy of corporate accounting statements. The SEC, however, does not have the resources to assure that accuracy.²⁶⁶ To remedy that shortcoming, the SEC has sought to convert accountants into policeman.²⁶⁷ In the first instance, this was done through industry self-regulation that was overseen by the SEC – a model that agency uses for exchange regulation.²⁶⁸ There are two prongs to this self-regulatory structure: one is generally accepted auditing standards (GAAS) and the second is generally accepted accounting principles (GAAP).²⁶⁹ The first prong, GAAS, have been produced by the Auditing Standards Board of the American Institute of

²⁶⁵ MURPHY, *supra* note 108, at 137.

²⁶⁶ See generally WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 82 (James Allen ed., 1940).

²⁶⁷ *Id.*

²⁶⁸ *Id.* Self-regulation has been described by Supreme Court Justice William O. Douglas, a former SEC chairman, as "letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." *Id.* Self-regulation has not been a success in assuring full disclosure. Instead, it has made a violator out of hundreds of individuals and firms in the business. This is best exemplified by the periodic list of NASD and disciplinary actions published in the Wall Street Journal. See, e.g., Michael Gerdes, *NYSE Disciplines Firms, Individuals*, WALL ST. J., Mar. 5, 2003, at B11A. Something is wrong with a regulatory system in which mass numbers of participants are violators.

²⁶⁹ See generally, DOUGLAS, *supra* note 266.

Certified Public Accountants (AICPA).²⁷⁰ The AICPA is a private professional organization of certified public accountants (CPAs), i.e., accountants passing rigorous examinations conducted by state boards of accountancy in order to assure proficiency in the profession.²⁷¹ CPAs are the accountants qualified to conduct audits and certify that a corporation's books and records are properly prepared.²⁷²

²⁷⁰ One court has described the nature and application of GAAS as follows:

The GAAS include 10 broadly phrased sets of standards and general principles that guide the audit function. They are classified as general standards, standards for fieldwork, and standards of reporting. General Standard No. 1 provides: "The examination is to be performed by a person or persons having adequate technical training as . . . auditor[s]." General Standard No. 3 provides: "Due professional care is to be exercised in the performance of the examination and the preparation of the report." Standard of Fieldwork No. 2 provides: "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." The generality of these statements is somewhat mitigated by the Statements on Auditing Standards (SAS), which are periodic interpretations of the standards issued by the Auditing Standards Board of the AICPA. . . . For example, SAS-55, which relates to internal financial control structure, includes steps to be followed in understanding and testing accounting control systems in relation to information provided in financial statements. . . . The GAAS Guide, a commonly used summary of GAAS, that purports to integrate and comprehensively restate pertinent auditing standards, includes 140 major sections and more than 1,000 pages.

Bily v. Arthur Young & Co., 834 P.2d 745, 750 (Cal. 1992) (citations omitted).

²⁷¹ *Id.* The Institute of Accountants and Bookkeepers was founded in New York in 1882. It gave examinations and certificates to those demonstrating proficiency in accounting. I MARKHAM, *supra* note 51, at 333. In 1896, New York adopted legislation that provided for state certification of public accountants who could demonstrate their expertise in the profession. THOMAS L. HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 1147 (2003). A predecessor of the AICPA, the American Institute of Accountants, had published a guide entitled "Uniform Accounting" in 1917 that contained guidelines on what steps should be taken in audits. II MARKHAM, *supra* note 67, at 91.

²⁷² *Arthur Young & Co.*, 834 P.2d at 750. One court has noted that:

Inherent in rendering an audit opinion is the recognition that financial statements cannot 'precisely' or 'exactly' present financial position, results of operations and cash flows. Such precision is unattainable. Consequently, an accountant's opinion that "the financial statements fairly present the financial condition of the Company in accordance with generally accepted accounting

The second prong of self-regulation is the concept of GAAP that falls under the oversight of the Financial Accounting Standards Board (FASB).²⁷³ GAAP seeks to assure that the accounting methodology properly discloses the company's financial activities and condition.²⁷⁴ GAAPs are actually practices that are generally accepted by the accounting profession in determining appropriate methodology or how to account for particular items.²⁷⁵ GAAPs may be legend and lore, rather than written principles.²⁷⁶ GAAPs must, however, be consistently applied.²⁷⁷ The FASB may issue written statements specifying a particular GAAP standard.²⁷⁸ Rule 203 of the AICPA Code of

principles" is not the same as stating that everything in the financial statement is perfect; rather, it means the financial statements are materially accurate and provide sufficient disclosure to users of the financial statements.

Koch v. Koch Industries Inc., 969 F. Supp. 1460, 1558–59 (D. Kan. 1997) (citations omitted).

²⁷³ Maureen Peyton King, *The SEC'S (Changing?) Stance on IAS*, 27 BROOK. J. INT'L L. 315, 317 (2001).

²⁷⁴ See generally Marshall S. Armstrong, *The Work and Workings of the Financial Accounting Standards Board*, 29 BUS. LAW. 145 (1974) (describing FASB).

²⁷⁵ *Id.*

²⁷⁶ See Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17, 27–40 (1998). A twenty-one person Accounting Principles Board (APB) was created by the AICPA in 1959 to review significant accounting questions and areas of inconsistency or where clarity was needed. *Id.* The AICPA also issues "Statements of Position" on various accounting issues. See *Trestman v. Microstrategy, Inc.*, No. 01-0685 § "K" (1), 2001 U.S. Dist. LEXIS 19668 (E.D. La. Nov. 15, 2001) (describing one such statement).

²⁷⁷ Walter Wriston, *The Solution to Scandals? Simpler Rules*, WALL ST. J., Aug. 5, 2002, at A10.

²⁷⁸ *Id.* GAAPs have been compiled in a 4,500 page, three-volume set. *Id.* Some rules are said to consume over 700 pages on how to book a single transaction. *Id.* FASB has acted on some on controversial GAAP issues, and issued guidance, but not until after years of study and lobbying by industry participants. See generally Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995) (describing and criticizing this statement). For example, treatment of goodwill after a merger was an issue fought over for decades before the FASB finally issued FASB Statement of Financial Accounting Standards No. 141—Business Combinations (2001) and FASB Statement No. 142—Goodwill and Other Intangible Assets (2001). *Id.* Accounting for derivatives was addressed after a number of off-balance sheet transactions resulted in large losses. Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133 [Original Pronouncements, Accounting Standards as of June 1, 2002], Fin. Acct. Standards Board (June 2000). Market-to-market accounting for trading activities was another prolonged

Professional Ethics requires compliance with accounting principles established by FASB.²⁷⁹ The FASB has not acted in all areas, resulting in varying GAAP standards and much uncertainty and giving rise to calls for an "Accounting Court."²⁸⁰

The SEC has deferred for the most part to the accounting profession in developing GAAPs, but on occasion has set its own accounting standards.²⁸¹ The SEC may impose particular standards required for accounting statements in filings by issuers.²⁸² This is done by rule and "Accounting Series Releases" on matters the SEC deems are not adequately addressed by the accounting profession.²⁸³ Regulation S-X, for example, imposes various accounting requirements in public offerings,²⁸⁴ and Staff Accounting Bulletin 101 sought to define when companies could record revenue on their books.²⁸⁵

Auditor Independence

On the auditing standards side, the AICPA created the Public Oversight Board (POB) that maintained oversight of a peer review program in which the accounting firms assessed the integrity of each other's audit practices.²⁸⁶ A problem encountered early on by

controversy on which the FASB eventually acted. FASB Statement of Financial Accounting Standards No. 107—Fair Value of Financial Instruments (1991). Disclosures about Fair Value of Financial Instruments, Statement of Financial Accounting Standards No. 107 [Original Pronouncements, Accounting Standards as of June 1, 2002] Fin. Acct. Standards Board (Dec. 1991). Most controversial of all was the blocking of the FASB's efforts to require the expensing of options granted to executives as compensation. See LEVITT, *supra* note 114, at 10–11, 108–11 (describing controversy).

²⁷⁹ Geier, *supra* note 276, at 38.

²⁸⁰ *Id.*

²⁸¹ See LEVITT, *supra* note 114, at 111–14. In recent years a dispute arose over control of the FASB. *Id.* Industry groups wanted it controlled by more business friendly individuals, while the SEC wanted it to have more public representation on its governing body, the Financial Accounting Foundation. *Id.* A fifty-fifty split was agreed upon, but the standard setting process remained mired in uncertainty. *Id.*

²⁸² See generally 17 C.F.R. § 210.1-01 (2002).

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ See *Trestman v. Microstrategy, Inc.*, No. 01-0685 § "K" (1), 2001 U.S. Dist. LEXIS 19668 (E.D. La. Nov. 15, 2001) (describing this bulletin).

²⁸⁶ LEVITT, *supra* note 114, at 126. The POB disbanded in 2002 after it became clear that an independent oversight body would be created. *Id.*

the SEC was that companies could simply fire auditors that refused to certify its accounts because of perceived irregularities or overly aggressive accounting methods that might mislead investors.²⁸⁷ This impaired the independence of the auditor because it would not want to lose the business.²⁸⁸ The SEC, therefore, required companies to disclose to the public in a Form 8-K whenever auditors are changed.²⁸⁹ The SEC further assumed the authority to discipline accountants that failed to meet what the SEC deemed appropriate auditing standards.²⁹⁰

Congress also acted by adopting legislation on auditor independence that sought to force accountants into the role of policemen. Section 10A of the Private Securities Litigation Reform Act of 1995 set forth audit requirements on the part of accountants certifying the statements of public corporations.²⁹¹ They are required to comply with GAAP and GAAS standards.²⁹² Moreover, this legislation required auditors to investigate any possible illegal acts they encounter during the audit and to inform management.²⁹³ If management does not act, and the matter is material, the auditor must report the issue to the board of directors.²⁹⁴ The board must then inform the SEC or the auditor must do so or resign the engagement.²⁹⁵ This legislation made the accountant a professional informer, “rat,” or whistleblower, depending on your view, which may be unique in our society. This

²⁸⁷ See generally Mindy Jaffe Smolevitz, *The Opinion Shopping Phenomenon: Corporate America's Search for the Perfect Auditor*, 52 BROOK. L. REV. 1077 (1987) (describing SEC concerns with this abuse).

²⁸⁸ *Id.*

²⁸⁹ See generally *id.*; 17 C.F.R. § 240.13a-11 (2002). As another spear pointing into the back of issuers, the Foreign Corrupt Practice Act requires public companies to maintain accurate books and records and to maintain a system of accounting controls that will assure the company's accounts are prepared in accordance with GAAP. 15 U.S.C. § 78m(b)(2) (2000).

²⁹⁰ 17 C.F.R. § 210.1-02(e) (2002).

²⁹¹ Andrew W. Reiss, *Powered by More Than GAAS: Section 10A of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride*, 25 HOFSTRA L. REV. 1261 (1997) (describing this legislation).

²⁹² See *id.*

²⁹³ 15 U.S.C. § 78j-1 (2000).

²⁹⁴ *Id.*

²⁹⁵ *Id.*

legislation also seems odd in having accountants determine what is legal when they are not lawyers.

The industry responded to independence concerns by creating the Independence Standards Board (ISB) to establish standards for auditor independence, but it was too pacific for the SEC.²⁹⁶ The SEC adopted its own auditor independence rules, but a subsequent SEC investigation of PricewaterhouseCoopers uncovered an astonishing 8,000 violations of the prohibition against ownership of client stocks.²⁹⁷ Thirty-one of the firm's top forty-three partners owned stock in audit clients.²⁹⁸

Auditor independence was being challenged from another direction. Accounting firms were losing interest in their audit business with its attending litigation and reputational costs. They began operating consulting operations for tax and other services, which grew quickly and became competitors with the audit services.²⁹⁹ Consulting services were creating conflicts of interest when advice was given by the consulting arm for an audit client to engage in aggressive accounting practices for tax, credit ratings, or stock price reasons. This led to much criticism, but more interesting was the acrimony in the accounting firms as their consulting arms began to outpace the audit teams.³⁰⁰ The accounting firms were also becoming law firms. In 1999, PricewaterhouseCoopers announced plans to become one of the largest law firms in the country within five years.³⁰¹ Ernst & Young created a law firm in Washington, D.C.³⁰²

These and other events raised alarm bells at the SEC, and the SEC decided to revise its auditor independence rules.³⁰³ In doing

²⁹⁶ LEVITT, *supra* note 114, at 119-20.

²⁹⁷ II MARKHAM, *supra* note 67, at 257; 17 C.F.R. § 210.2-01(b) (2002).

²⁹⁸ II MARKHAM, *supra* note 67, at 257.

²⁹⁹ See LEVITT, *supra* note 114, at 8. The percentage of accounting firm revenues from management consulting grew from one-third in 1993 to fifty one percent in 1999. *Id.*

³⁰⁰ Markham, *supra* note 17, at 257.

³⁰¹ *Id.*

³⁰² *Id.*

³⁰³ See Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 42994, [2000 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 86,315, at 83, 527-30 (June 30, 2000).

so, the SEC noted the changing nature of the accounting industry.³⁰⁴ It found that, far from being policeman, accounting firms were becoming primarily business advisory service firms as they increased revenues from non-audit services.³⁰⁵ Accounting firms were entering into business relationships such as strategic alliances, co-marketing arrangements, and joint ventures with audit clients and were offering ownership of parts of their practices to others, including audit clients.³⁰⁶ The accounting firms were merging with each other, resulting in increased firm size, both domestically and internationally, and expanding into international networks.³⁰⁷ Audit clients were also found to be hiring an “increasing number of accounting firm partners, professional staff, and their spouses for high level management positions.”³⁰⁸

The SEC, thereafter, adopted rules to reflect these changes. Among other things, those rules clarified the circumstances under which an auditor would retain independence in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients. The rules identified certain non-audit services that could impair the auditor’s independence.³⁰⁹ The SEC rules established four broad standards for measuring whether activities would impair auditor independence.³¹⁰ Standards for determining whether non-audit services would impair independence were also specified.³¹¹

These rules were alarming because they promised what the SEC could not deliver, *viz.*, that auditor independence will assure accurate accounting and full disclosure. The SEC stated its position in ringing tones:

³⁰⁴ *Id.*

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.*

³⁰⁹ Revision of the Commission’s Auditor Independence Requirements, No. 43,602 (Nov. 21, 2000).

³¹⁰ *Id.*

³¹¹ THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 9.6 (4th ed. 2002).

Independent auditors have an important public trust. Every day, millions of people invest their savings in our securities markets in reliance on financial statements prepared by public companies and audited by independent auditors. These auditors, using Generally Accepted Auditing Standards ("GAAS"), examine issuers' financial statements and issue opinions about whether the financial statements, taken as a whole, are fairly presented in conformity with Generally Accepted Accounting Principles ("GAAP"). While an auditor's opinion does not guarantee the accuracy of financial statements, it furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional and that investors can therefore rely on them. Providing that assurance to the public is the auditor's overarching duty.

Investors must be able to put their faith in issuers' financial statements. If investors do not believe that the auditor is truly independent from the issuer, they will derive little confidence from the auditor's opinion and will be far less likely to invest in the issuer's securities. Fostering investor confidence, therefore, requires not only that auditors actually be independent of their audit clients, but also that reasonable investors perceive them to be independent.³¹²

The collapse of Enron and several other large companies and a wave of restated earnings would prove that this was a hollow promise. Accountant certifications did not, and could not provide this protection and confidence.

In the event, accounting firms began divesting themselves of their consulting businesses. Andersen Consulting partners voted to split themselves off from the less profitable Arthur Andersen audit group and became Accenture.³¹³ PricewaterhouseCoopers

³¹² Revision of the Commission's Auditor Independence Requirements, Fed. Sec. L. Rep. (CCH) ¶ 86,315 at 83,528. The SEC further stated that:

One of our missions is to promote investor confidence in the reliability and integrity of issuers' financial statements. To promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society.

Id.

³¹³ MARKHAM, *supra* note 17, at 257.

separated its audit unit from its management consulting practice to remove conflicts, spinning off its consulting operations to IBM.³¹⁴ and Ernst & Young sold consulting operations for \$4.8 billion.³¹⁵ Deloitte & Touche initially decided to retain its consulting business,³¹⁶ but later decided to sell, but then changed its mind once again.³¹⁷ Even so, the accounting firms' revenues in 2003 from consulting were still exceeding those from auditing.

The Full Disclosure System is Flawed

Enron and Other Accounting Failures

The SEC was observing a number of accounting problems as the market bubble grew at the end of the 1990s.³¹⁸ The SEC chairman was complaining vociferously of such things as "channel stuffing"³¹⁹ and "cookie jar reserves" that were being used by companies to manage their earnings.³²⁰ *Pro forma* earnings

³¹⁴ William M. Bulkeley & Kemba Dunham, *IBM Speeds Move to Consulting with \$3.5 Billion Acquisition*, WALL ST. J., July 31, 2002, at A1.

³¹⁵ *Id.*

³¹⁶ *Id.*

³¹⁷ Kemba J. Dunham, *Consulting Unit of Deloitte Plans to Go Private*, WALL ST. J., June 7, 2002, at C5.

³¹⁸ Freddie Mac and Fannie Mae were even under attack for not disclosing their accounting policies. The federal government later sought to force them to adopt corporate disclosure practices used by other private companies. Patrick Barta, *Freddie Mac, Fannie Mae Face Disclosure Rules*, WALL ST. J., July 2, 2002, at A2.

³¹⁹ Channel stuffing involves sending unneeded goods to customers in order to increase revenues. See *SEC v. Dunlap*, Fed. Sec. L. Rep. (CCH) ¶ 91,771 (S.D. Fla. Mar. 27, 2002) (describing channel stuffing scheme). Some less imaginative executives simply listed expenses as assets and over stated accounts receivable. *SEC Sanctions FLIR Systems, Sues Former Officers for Inflating Earnings*, 34 SEC. REG. & L. REP. NO. 43, at 1806 (Nov. 4, 2002).

³²⁰ See LEVITT, *supra* note 117, at 163. Cookie jar reserves may be created by such practices as creating inflated loss reserves that can be reduced in the future to increase earnings. *Id.* The use of hidden reserves to manage earnings is actually an accepted practice in many other countries. The SEC has for years been on a crusade against the acceptance of international accounting standards that allow the use of such secret reserves, which excluded many foreign companies from United States markets, impeding cross-border capital flows. The SEC required foreign firms seeking access to American markets to reconcile their financial statements with GAAP. More recently, the SEC has been softening its opposition to international standards. The creation of an International

announcements that were not prepared in accordance with GAAP were being used to manipulate actual results.³²¹ Earnings

Accounting Standards Committee by some 100 accounting firms world wide, and its governing board, the International Accounting Standards Board (IASB), that the SEC was given a role in selecting, has been trying to lessen the SEC's concerns. Hal S. Scott & Philip A. Wellons, *International Finance, Transactions, Policy, and Regulation* (9th ed. 2002); see also James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999) (describing issues arising under application of international accounting standards); EDMUND COULSON, *INTERNATIONAL ACCOUNTING AND AUDITING*, C489 ALI-ABA 569 (Nov. 1989) (describing role of international accounting standards committee); Charles Canfield, *FASB v. IASC: Are the Structure and Standards Setting Process at the IASC Adequate for the Securities and Exchange Commission to Accept International Accounting Standards for Cross-Border Offerings?*, 20 NW. J. INT'L L. & BUS. 125 (1999) (describing role of international accounting standards committee); see generally Janice Grant Brunner, *All Together Now? The Quest for International Accounting Standards*, 20 U. PA. J. INT'L ECON. L. 911 (1999) (describing conflicts over application of international standards); Scott B. Novak, *A Step Toward Globalization: The Move for International Accounting Standards*, 9 IND. INT'L & COMP. L. REV. 203 (1998) (describing conflicts over application of international standards). The SEC issued a concept release in 2000 that sought comment on the development of a set of broad standards for determining whether an international accounting method met the SEC's goals of full disclosure. SEC Concept Release: *International Accounting Standards*, [1999-2000 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 86,237 at 82,969 (Feb. 16, 2000). The subsequent collapse of Enron Corp. and ensuing scandals has thrown that project into an era of uncertainty, but work continues. See *IASB and FASB Signal Commitment to Cut Accounting Differences in Accounting Rules*, 34 SEC. REG. & L. REP. NO. 34, at 1566 (Sept. 23, 2002) and *SEC Members, EC Hail Accord Reached by U.S., International Rulemakers*, 34 SEC. REG. & L. REP. NO. 43, at 1808 (Nov. 4, 2002) (FASB and IASB continue to seek to reconcile differences between GAAP and international standards). Enron also gave rise to debates over whether American generally accepted accounting principles standards should be followed rather than the principle based international accounting standards that allow more discretion than does GAAP. *The Impossible Dream*, THE ECONOMIST, Mar. 2, 2002, at 69. The FASB has published a proposal for principle-based accounting. FEDERAL ACCOUNTING STANDARDS BOARD, PROPOSAL: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING (2002) available at http://www.fasb.org/proposals/principles-based_approach.pdf.

Compounding this picture, the European Union is requiring its companies to use IASB standards by 2005, which will cause difficulties for European firms listing their stock in the United States unless reconciliation is achieved. Institutional investors in America would also like a single standard. Michael Skapinker, *Investors Look for Single Accounting Standard*, FIN. TIMES, July 8, 2002, at 21.

³²¹ See *In the Matter of Trump Hotels & Casino Resorts, Inc.*, Exchange Act Release No. 45,287 (Jan. 16, 2002) (administrative sanctions imposed by consent for misstating *pro forma* results), available at 2002 WL 58566. *Pro forma* results may exclude certain events such as a one-time charge in order to allow investors to assess the underlying business unaffected by an extraordinary event. The SEC was concerned that bad events were excluded, while one time good events were left in the *pro forma* results.

restatements were rare before 1995.³²² Between 1998 and the first half of 2002, however, there were over 650 accounting restatements by public corporations.³²³ That number continued to swell. For the entire year in 2002, there were 330 restatements, up from 270 in 2001.³²⁴ Accounting failures were said to have cost investors \$88 billion between 1993 and 2000.³²⁵

Something was definitely wrong with full disclosure. The market collapse that began in 2000 exposed even more disturbing flaws in the full disclosure network. At the center of this debacle were failures in accounting. Enron and its auditor, Arthur Anderson, came under scrutiny for failing adequately to disclose the accounting practices of Enron that allowed the company to keep large liabilities off its balance sheet, sometimes using special purpose vehicles in which management had invested.³²⁶ Enron

Id. An analyst at Merrill Lynch announced that he would no longer rely on pro forma announcements, unless they were prepared in accordance with GAAP. *Merrill Analyst Shifts His Accounting Focus in Making Forecasts*, N.Y. TIMES, Mar. 7, 2002, at C8. The SEC also adopted a rule requiring companies to state when their pro forma reports are not in accordance with GAAP. Michael Schroeder, *SEC Orders New Disclosures on Company Earnings*, WALL ST. J., Jan. 16, 2003, at A2.

³²² FOX, *supra* note 167, at 246. Only three companies restated earnings in 1981. LEVITT, *supra* note 114, at 117.

³²³ Jonathan Clements, *Damage Control: What You Need to Do Now*, WALL ST. J., June 27, 2002, at D1.

³²⁴ Cassell Bryan-Low, *Restatements Rise 22%*, WALL ST. J., Jan. 21, 2003, at C3.

³²⁵ Mike McNamee et al., *Accounting Wars*, BUS. WEEK, Sept. 25, 2000, at 156.

³²⁶ Enron's stock traded as high as \$90 before dropping below \$1 just before it declared bankruptcy. Enron's demise was triggered by accounting issues over special purpose entities (SPEs) called such things as "Raptors", Chewco", and "JEDI." They were special purpose entities that operated as limited partnerships and were used to take losses off of its books and to increase earnings. Accounting rules allowed an entity that was only three percent owned by outside parties to be removed from the books of a company owning ninety-seven percent. Chewco failed to meet this requirement, falling short by about one percent or \$3 million. *See generally* SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION (Feb. 1, 2002) (describing accounting shortcuts taken by Enron), *available at* <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>; Leslie Wayne, *Chagrined Enron Partners Try to Stave off Both Losses and Scandal's Taint*, N.Y. TIMES, Mar. 31, 2002, at 20 (describing other off-the-books partnerships). Michael Kopper, a financial executive at Enron, pleaded guilty to two felony counts of fraud in connection with special purpose entities used by Enron, including Chewco. *The Enron and Tyco Cleanups*, WALL ST. J., Aug. 22, 2002, at A12. The FASB later increased the independence requirement for SPE ownership, adding some additional control tests. Jackie Spinner, *Rules Mean Uncertainty for Enron-Style 'SPEs'*, WASH. POST, Jan. 24,

announced a \$1.01 billion charge resulting from limited partnerships, including one operated by the firm's chief financial officer.³²⁷ This resulted in a \$618 million third-quarter loss for the company in 2001.³²⁸ Enron did not survive the resulting firestorm, and it became the largest bankruptcy in American history, although that record was soon bested by an even larger accounting scandal and bankruptcy at WorldCom, Inc. At the time of its bankruptcy, Enron was the seventh largest company in the United

2003, at E01. Enron also used synthetic leases as substitutes for loans, allowing those obligations to be kept off the balance sheet. FOX, *supra* note 162, at 120. Another device used were so-called prepaid forward contracts that were later claimed to be simply disguised loans made to Enron by J.P. Morgan-Chase. Jathon Sapsford, et al., *Lenders' Deals Aided Energy-Firm Results*, June 26, 2002, at C1. A settlement was reached before this issue was submitted to a jury. *Jurors Were Divided Over Morgan's Lawsuit*, N.Y. TIMES, Jan. 4, 2003, at C2. The Manhattan district attorney's office was also investigating these transactions. Paul Beckett & Laurie P. Cohen, *J.P. Morgan is Still Shadowed by Enron Links*, WALL ST. J., Jan. 16, 2003, at C1. Loans were pushed off balance sheets using other devices including the use of collateralized debt obligations. Jonathan Weil & Henny Sender, *Loose Audit Rules Keep Debt Defaults off Books for Now*, WALL ST. J., Jan. 15, 2003, at C1. Another financial instrument used by Enron was something called monthly income preferred shares (MIPS). These instruments made periodic payments to investors that were treated as interest payments for income tax purposes but were used by rating agencies as equity in order to reduce the amount of leverage on the company's balance sheet. It was thus both a stock and a loan at the same time. John D. McKinnon & Greg Hitt, *Double Play: How Treasury Lost a Battle to Quash a Dubious Security*, WALL ST. J., Feb. 4, 2002, at A1. Enron had problems beyond the accounting issues with its balance sheet manipulations. Enron was also blamed for the California energy crisis, which arose as the result that state's failure to expand its power generation sources and market supplies. Enron was in the forefront of a war between market forces and government regulation. California claimed that Enron and other energy traders were manipulating prices in energy contracts in order to profit at the expense of California consumers. The market eventually forced a solution by increasing prices and decreasing demand, as well as requiring more practical management of energy supplies. Enron was engaging in such things as "ricochet" trades "fat boy," "Get Shorty," and "Death Star." Julie Earle, *The Round Trips to Nowhere*, FIN. TIMES, May 15, 2002, at 19. Other energy trading firms had been engaged in so-called "round trip" transactions, buying and selling to themselves in order to boost their trading volumes. Among the firms engaged in such activities were CMS Energy, Dynegy, and Reliant Resources. Nancy Dunne & Julie Earle, *Regulators 'Knew About Bogus Energy Trades'*, FIN. TIMES, May 16, 2002, at 10.

³²⁷ Nima Warfield, et al., *One Year, Two Worlds: What Was News in 2001*, WALL ST. J., Jan. 2, 2002, at R12.

³²⁸ *Id.* Several indictments followed the Enron collapse. FOX, *supra* note 162, at 162.

States.³²⁹ One newspaper claimed, however, that if Enron had properly accounted for its operations, the firm would have ranked only 287 in the list of the country's largest companies.³³⁰ Arthur Andersen was also destroyed in the Enron scandal after being convicted of obstruction of justice in connection with its handling of Enron documents.³³¹

Accounting Implosions

The political outcry over Enron and other accounting problems undermined confidence in the SEC's full disclosure system and accounting in general. To restore that confidence, the SEC required chief executive officers and chief financial officers of the largest publicly traded companies to swear that their financial statements were accurate. A total of sixteen of about 950 responding companies were unable to certify to the accuracy and completeness of their companies' reports and filed explanations.³³² In the end, the SEC's loyalty oath requirement was only cosmetics. The system was simply too broken to patch so easily.

Arthur Andersen's problems at Enron were not its only transgressions in failing to fulfill its role as a quasi-governmental policeman. The accounting firm had previously settled for \$7 million in an SEC suit charging fraud in its audit of Waste Management.³³³ Arthur Andersen and the company agreed to settle

³²⁹ *Enron's Bankruptcy: Wasted Energy*, THE ECONOMIST, Dec. 8, 2001, at 13.

³³⁰ SIEBERT, *supra* note 114, at 221.

³³¹ See Jonathan Weil, et al., *Anderson Win Lifts U.S. Enron Case*, WALL ST. J., June 17, 2002, at A1. The government decided that 85,000 Andersen employees worldwide should be put out of work for the wrongdoing of a few. Markham, *supra* note 220. In comparison, it appears that there were some 5,300 layoffs at Enron following the bankruptcy of a total work force of about 25,000 in all the Enron entities. Fox, *supra* note 162, at 288. Only sixty-eight of Enron's 3,500 companies initially filed for bankruptcy. *Id.* at 287. Arthur Andersen was one of the "Big Five" accounting firms. It was founded in 1914 by a twenty-eight year old Northwestern University accounting professor. The firm grew over the years into a behemoth with worldwide operations and 158 campuses where it taught entering accountants. The accounting firm was generating \$9.3 billion in revenue when the scandal broke. Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen's Fall from Grace is a Tale of Greed and Miscues*, WALL ST. J., June 7, 2002 at A1.

³³² See generally www.SEC.gov.

³³³ Waste Management itself announced in November 2001 that it was paying \$457 million to settle a class action securities suit involving these problems. Warfield, *supra* note 286, at R16. This raises the question of who is actually paying the damages. It

shareholder lawsuits arising from the Waste Management problem for \$220 million in 1998.³³⁴ Arthur Andersen also paid \$110 million as a settlement of a lawsuit involving Sunbeam in 2000.³³⁵ The firm was charged with having certified Sunbeam's accounting statements despite the fact that a large amount of fake profits were reported.³³⁶

These were not events isolated within Arthur Andersen. In January 2002, the SEC reached a settlement with KPMG in which the accounting firm was charged with improperly investing in a mutual fund that was administered by an investment company the accounting firm audited.³³⁷ The accounting firm invested \$25 million in this mutual fund.³³⁸ KPMG was also censured by the SEC.³³⁹ The SEC has also accused KPMG of failing to police the accounting practices of Xerox that resulted in \$6.4 billion in restated earnings by that corporation.³⁴⁰ Ernst & Young paid \$335 million in 1999 to settle a suit brought by investors in CUC International.³⁴¹ Ernst & Young was also in trouble with the regulators.³⁴² The Federal Deposit Insurance Corporation filed a \$2 billion suit against the accounting firm in connection with the failure of the Superior Bank in a Chicago suburb.³⁴³ The FDIC charged that the accounting firm failed to properly audit the books and records of the bank, allowing that bank to engage in fraud in

seems that the shareholders are either paying themselves back or foisting the loss off onto subsequent equally innocent shareholders.

³³⁴ FOX, *supra* note 167, at 182.

³³⁵ *Id.*

³³⁶ *Id.* The Andersen audit partner on the engagement was barred from practicing as an accountant before the SEC for at least three years. *Financial Fraud, Audit Partner, Former Sunbeam Officials Settle SEC charges over Alleged Scheme*, 35 SEC. REG. & L. REP. NO. 5, at 208 (Feb. 3, 2003).

³³⁷ Judith Burns & Jonathan Weil, *SEC Censures KPMG Over Investment*, WALL ST. J., Jan. 15, 2002, at C17.

³³⁸ *Id.*

³³⁹ *Id.*

³⁴⁰ Adrian Michaels, *KPMG Accused of Ignoring Xerox Alerts*, FIN. TIMES, Jan. 30, 2003, at 21.

³⁴¹ Adrian Michaels & Michael Peel, *Andersen Faces Deloitte Touche Investigation*, FIN. TIMES, Dec. 3, 2001, at 28.

³⁴² See *Ernst & Young Faces \$2bn Suit*, FIN. TIMES, Nov. 2-3, 2002, at 18.

³⁴³ *Id.*

the sale of securitized assets, but that suit was later dismissed by a federal court.³⁴⁴

Accounting scandals were endemic elsewhere. As noted, Xerox confessed that it had accelerated revenue improperly from 1997 through 2001 in amounts totaling \$6.4 billion.³⁴⁵ Reliant Resources Inc. announced in July of 2002 that it was restating its earnings for a three-year period as a result of an artificial inflation of its revenues by more than \$7.8 billion.³⁴⁶ That action was the result of “round trip” trades in electricity that bought and sold at the same quantity and price in order to pump up the firm’s trading volumes.³⁴⁷ Bristol-Myers Squibb, the pharmaceutical company, announced in October of 2002 that it was restating over \$2 billion in inflated sales figures.³⁴⁸ The Rite Aid Corporation’s restatement was for \$1.6 billion in various years in the late 1990s.³⁴⁹ Former executives at Rite Aid were indicted for fraudulently inflating profits of the company.³⁵⁰ Its chief executive officer, Martin Grass, was facing charges of accounting fraud, false statements to the government, and obstruction of justice by tampering with a witness.³⁵¹ An executive at Symbol Technologies pled guilty to federal charges that he inflated earnings to meet Wall Street expectations for that company.

The president of Critical Path Inc. pleaded guilty to charges that he falsified company revenues for 2000.³⁵² The stock value subsequently dropped from \$3.8 billion to \$192 million.³⁵³ At the

³⁴⁴ *Id.*

³⁴⁵ Mark Maremont & James Bandler, *Deeper Accounting Woes at Xerox*, WALL ST. J., June 28, 2002, at A3.

³⁴⁶ *In SEC Filing, Reliant Restates Three Years of Inflated Earnings*, SEATTLE POST-INTELLIGENCER, July 6, 2002 at D1.

³⁴⁷ *Id.*

³⁴⁸ *Seeing Red*, FIN. TIMES, Oct. 25, 2002, at 22.

³⁴⁹ Gary Strauss, *America’s Corporate Meltdown*, USA TODAY, June 27, 2002, at 1A.

³⁵⁰ *Id.*

³⁵¹ Scott Kilman, *Rite Aid Ex-Officials Charged in Accounting-Fraud Probe*, WALL ST. J., June 24, 2002, at A2.

³⁵² *Ex-Critical Path Official Pleads Guilty to Plot of Exaggerating Revenue*, WALL ST. J., Feb. 14, 2002, at B7.

³⁵³ *Id.* AOL was facing a \$1 billion liability over claims that it inflated revenues. *What’s News*, WALL ST. J., May 1, 2003, at A1.

same time, Take-Two announced that it was the subject of an SEC investigation for certain of its accounting practices.³⁵⁴ Cendant Corp. inflated \$500 million in earnings on its records, embarrassing its auditor—Ernst & Young.³⁵⁵ PNC Financial was required to restate its earnings twice for 2001.³⁵⁶ The total restatement reduced earnings by \$377 million, a reduction of about one third of the previously reported earnings.³⁵⁷

Vivendi wrote down over \$12 billion of assets in the form of corporate goodwill,³⁵⁸ but that paled in comparison to the \$54.2 billion written off by AOL Time Warner.³⁵⁹ Cisco Systems, Inc. took a \$2.8 billion write down on inventory.³⁶⁰ An executive at Tyco, who had been indicted for not paying state sales taxes on expensive paintings, was also found to have looted as much as \$175 million from the corporation, using the funds for such things as a \$6,000 shower curtain and a \$2.1 million birthday party for his wife on the island of Sardinia where singer Jimmy Buffett was imported for her entertainment.³⁶¹ Tyco, thereafter, announced a \$6 billion charge against earnings³⁶² that was said to be the result of “a pattern of aggressive accounting” designed to inflate earnings.³⁶³ Other executives had been similarly greedy. A survey by the *Financial Times* concluded that in the three years prior to August 2002 the top executives and directors involved in major business collapses in the United States were paid about \$3.3

³⁵⁴ Aaron Elstein & Cindy Perman, *Take Two Announces SEC Investigation*, WALL ST. J., Feb. 14, 2002, at B8.

³⁵⁵ III MARKHAM, *supra* note 132, at 343.

³⁵⁶ Gary Silverman, *PNC to Restate Its Results Again*, FIN. TIMES, Feb. 20, 2002.

³⁵⁷ *Id.*

³⁵⁸ John Carreyrou, *Vivendi Posts Big Loss for 2001 After Write-Down of Goodwill*, WALL ST. J., Mar. 6, 2002, at B2. Tyco subsequently announced a further \$1.1 billion restatement in April 2003. *What's News*, WALL ST. J., May 1, 2003, at A1.

³⁵⁹ *Business*, THE ECONOMIST, Apr. 27, 2002, at 7. AOL Time Warner later announced that it was also restating some \$480 million in revenues for the years 2001 and 2002. *Other News*, FIN. TIMES (London), Mar. 29-30, 2003, at 1.

³⁶⁰ LEVITT, *supra* note 114, at 164-65.

³⁶¹ Mark Maremont & Laurie P. Cohen, *How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

³⁶² Peter Larsen, *Tyco May Take \$6bn Hit in CIT Disposal*, FIN. TIMES, June 6, 2002, at 25.

³⁶³ *What's News*, WALL ST. J., Dec. 31, 2002, at A1.

billion. At the same time these enormous sums were being paid out, those companies also laid off some 100,000 workers and hundreds of billions of shareholder value were lost.³⁶⁴ That report led Eliot Spitzer, the New York State Attorney General, to commence an investigation of those executives.³⁶⁵

The telecoms were at center of an ocean of red ink and accounting fraud. Seventeen of those companies saw their stock values drop a collective \$1 trillion, "not to mention another thousand related bankruptcies."³⁶⁶ AT&T took a \$1 billion restructuring charge in the last quarter of 2001 and cut 10,000 jobs.³⁶⁷ Global Crossing, a fiber optic telecom carrier whose valuation had reached \$50 billion, filed for bankruptcy.³⁶⁸ It became the fourth largest bankruptcy in United States history.³⁶⁹ Nortel Networks, a telecommunications firm, saw its chief financial officer resign as a result of some improper personal investments. Nortel's stock price had dropped almost ninety percent in the prior two years. That was a loss of \$140 billion in market value.³⁷⁰ WorldCom, Inc. and Qwest Communications International, one of the Baby Bells, announced write-offs of \$60 billion in goodwill as a result in the change in accounting rules for merger-acquired goodwill.³⁷¹ Qwest was also defending itself in the press against claims that it had improperly accounted for

³⁶⁴ Ien Cheng, *\$3.3bn for Executives of Failed Companies*, FIN. TIMES, July 31, 2002, at 1.

³⁶⁵ Lionel Barber, et al., *New York State Attorney General Probes Awards to Heads of Bankrupt Groups*, FIN. TIMES, Aug. 1, 2002, at 1; see Caroline Daniel, et al., *Insiders Who Managed to Get Out Just in Time*, FIN. TIMES, Aug. 1, 2002.

³⁶⁶ George Gilder, *Broadband's Narrow Minds*, WALL ST. J., Feb. 19, 2003, at A14; Holman W. Jenkins Jr., *CEOs Who Can't Let Go of Their Stock*, WALL ST. J., Feb. 12, 2003, at A17.

³⁶⁷ *What's News*, WALL ST. J., Jan. 7, 2002, at A1.

³⁶⁸ *Business, Survival of the Slowest*, THE ECONOMIST, Feb. 2, 2002, at 9.

³⁶⁹ LEVITT, *supra* note 114, at 144.

³⁷⁰ Justin Bear, *Nortel Issues Gloomy Report*, NEWS & OBSERVER (Raleigh, N.C.), Feb. 13, 2002, at D1. One magazine noted that, if an investor had purchased \$100,000 of Nortel stock in July 2001, it would have been worth only \$5,483.52 in December of 2001. In contrast, if the same investor had bought \$100,000 of bottled beer, that investment would be worth \$10,006.50 in empty returnable bottles. MAXIM MAGAZINE, Dec. 2001, at 46.

³⁷¹ Thorold Barker & Peter Thal Larsen, *U.S. Telecoms Groups May Have to Write Off \$60bn in Goodwill*, FIN. TIMES, Feb. 25, 2002, at 21.

certain equipment sales to KMC Telecom Holdings, Inc.³⁷² The company restated \$2.2 billion in revenue. Four of its executives were indicted for inflating the company's revenues.³⁷³ Qwest was among those engaging in dubious accounting practices designed to bolster its financial results.³⁷⁴ That firm engaged in swaps in phone connections with other companies which would constitute revenue.³⁷⁵ The firm later had to restate those swaps.³⁷⁶ Lucent Technologies, Inc. restated \$679 million in revenue for a single quarter.³⁷⁷ Charter Communications, a cable company, over stated its revenues by almost \$300 million over a three-year period.

WorldCom announced that it had engaged in a staggering \$9 billion in fraudulent accounting entries³⁷⁸ designed to boost its stock performance.³⁷⁹ The company was delisted from Nasdaq,³⁸⁰ and on July 21, 2002, WorldCom filed for Chapter 11 bankruptcy. WorldCom shoved Enron aside to take the dubious title of the largest bankruptcy in history.³⁸¹ On October 1, 2002, Elliot Spitzer, the New York Attorney General, brought charges against five individuals including former WorldCom CEO Bernard Ebbers, claiming that they had improperly profited by more than \$1.5 billion from shares given to them in IPOs as an inducement for them to direct their company's business to investment banking firms such as Salomon Smith Barney.³⁸² As noted, this practice

³⁷² Deborah Solomon, *Qwest Defends Accounting Practices, Says It Disclosed KMC Deal to Investors*, WALL ST. J., Feb. 14, 2002, at B8.

³⁷³ Dennis Berman & Deborah Solomon, *Ex-Executives Are Indicted in Qwest Probe*, WALL ST. J., Feb. 26, 2003, at B1.

³⁷⁴ Dennis K. Berman, et al., *Tricks of the Trade, As Market Bubble Neared End, Bogus Swaps Provided a Lift*, WALL ST. J., Dec. 23, 2002, at A1.

³⁷⁵ *Id.*

³⁷⁶ *Id.*

³⁷⁷ Lucent was spared SEC sanctions because it caught the error before filing its quarterly report with the SEC. Dennis Berman, *SEC Ends 2-Year Lucent Probe With Accord Carrying No Fines*, WALL ST. J., Feb. 28, 2003, at B7.

³⁷⁸ *SEC: WorldCom Misstated Earnings by \$9 Billion*, N.Y. L.J., Nov. 6, 2002, at 1.

³⁷⁹ *WorldCom Fraud Rises \$3.3 Billion*, ROCHESTER DEMOCRAT & CHRON., Aug. 9, 2002, at 12D.

³⁸⁰ Deborah Solomon, et al., *WorldCom Angers Regulators as Accounting Scandal Widens*, WALL ST. J., July 2, 2002, A1.

³⁸¹ *What's News*, WALL ST. J., July 22, 2002, at A1.

³⁸² Charles Gasparino, *New York Sues Telecom Executives Over Stock Profits*,

was similar to the use of “preferred” accounts used by J.P. Morgan and others back in the 1920s, which were roundly criticized. In a return to pre-SEC regulation, Spitzer used the Martin Act to investigate and prosecute those executives.

Two senior executives at the Sprint Corp. were forced to resign after it was revealed to their board of directors that they had used a dubious tax shelter to avoid paying taxes on over \$100 million of income from stock options they had been awarded as bonuses. These executives used a tax shelter recommended by the auditor for the Sprint Corp. Company policy required the executives to use Sprint’s auditor for the preparation of their tax returns and allowed them to use the tax advice services of the auditor.³⁸³ Adelphia, the cable company, announced that it had overstated revenue and cash flow by some \$500 million over a two-year period.³⁸⁴ Adelphia was also a co-borrower of \$3.1 billion in loans to a partnership owned by its founding family, the Rigas.³⁸⁵ The family used \$1.4 billion of that loan to buy company stock.³⁸⁶ Adelphia filed for bankruptcy on June 25, 2002. It was then the nation’s sixth largest cable company.³⁸⁷ The founder of Adelphia, the giant cable television company, was arrested, along with his two sons, for looting the company.³⁸⁸ Underscoring the cynicism engendered by the federal securities laws, Adelphia brought suit against its auditor Deloitte & Touche for failing to stop the company’s own executives from their alleged looting.³⁸⁹

Attorney General Spitzer Seeks Return of 1.5 Billion Citing Solomon Dealings, WALL ST. J., Oct. 1, 2002, A1, at A10; see generally Smith & Pulliam, *supra* note 227 (describing this practice); Susan Pulliam, et al., *Easy Money, Former WorldCom CEO Built an Empire on Mountain of Debt*, WALL ST. J., Dec. 31, 2002, at A1 (describing some abuses).

³⁸³ Rebecca Blumenstein & Carol Hymowitz, *Troubling Options, Inside the Tough Call at Sprint: Fire Auditor or Top Executives*, WALL ST. J., Feb. 10, 2003 at A1.

³⁸⁴ *What’s News*, WALL ST. J., June 11, 2002, at A1; Deborah Solomon, *Adelphia Overstated Cash Flow, Revenue, Over Past Two Years*, WALL ST. J., June 11, 2002, at A1.

³⁸⁵ Solomon, *supra* note 372.

³⁸⁶ Deborah Solomon, *Salomon Draws Focus by SEC Over Adelphia*, WALL ST. J., June 5, 2002, at C1.

³⁸⁷ Deborah Solomon, *Adelphia Communications Files for Bankruptcy-Court Protection*, WALL ST. J., June 26, 2002, at A3.

³⁸⁸ *What’s News*, WALL ST. J., July 26, 2002, at A1.

³⁸⁹ Jonathan Weil, *Deloitte’s Work for Ahold Raises Audit Questions*, WALL ST. J.,

More problems followed for Deloitte & Touche after Ahold, N.V., one of the largest grocery distribution chains in the world, announced in 2003 that it was restating \$500 million in revenue. Ahold, a Dutch company with large operations in the United States, listed its shares through ADRs on the New York Stock Exchange.³⁹⁰ Deloitte & Touche discovered those discrepancies but not until after auditing and certifying earlier statements that were now being restated.³⁹¹ This event triggered SEC investigations into the accounting practices of other grocery distributors, including Fleming Co., the worlds largest such distributor that had previously been the subject of stories claiming that it had engaged in sharp practices with suppliers in order to boost revenues. Another food distributor, Nash Finch Co., was also under investigation for its accounting practices.³⁹²

Lehman Brothers was under SEC investigation for its accounting disclosures concerning its exposure to the Russian securities market.³⁹³ Gateway, the computer maker, announced that it was restating \$500 million in revenues for the years 2001 and 2002. Provident Financial in Cincinnati announced that it was restating its profits for a six year period, reducing its profits by twelve percent during those periods.³⁹⁴ An executive at Symbol Technologies pled guilty to criminal charges in connection with the inflating of revenues at that company by more than ten percent and totaling several hundred million dollars.³⁹⁵ HealthSouth Corp.,

Feb. 25, 2003, at A10.

³⁹⁰ Deborah Ball & Steve Stecklow, *Supermarket Firm Ahold Faces U.S. Inquiries*, WALL ST. J., Feb. 26, 2003, at A2; Ahold was not the only foreign firm experiencing losses. Deutsche Telekom had a loss of \$27.1 billion in 2002, a German record. *What's News*, WALL ST. J., March 11, 2003, at A1.

³⁹¹ *Id.*

³⁹² Ann Zimmerman & Patricia Callahan, *Payments to Distributors Draw Scrutiny, Fleming Now Faces a Formal Probe*, WALL ST. J., Feb. 26, 2003, at A2; Accounting practices at other food service firms, including Sara Lee and ConAgra Foods, Inc., were being investigated. Anita Raghavan & Deborah Ball, *Ahold Investigation May Expand*, WALL ST. J., Mar. 28, 2003, at A3.

³⁹³ Nikki Tait, *Lehman Accused Over Russian Exposure*, FIN. TIMES Feb. 21, 2003, at 15, available at LexisNewsGroup File (last visited Mar. 31, 2003).

³⁹⁴ Joseph T. Hallinan, *Provident Financial to Restate Profits for 6 Years, Cuts Outlook*, WALL ST. J., Mar. 6, 2003, at B2.

³⁹⁵ Kara Scannell, *Ex-Official at Symbol Pleads Guilty*, WALL ST. J., Mar. 26, 2003, at C7.

an out patient health care business, was charged with falsifying \$1.4 billion in profits over a five-year period.³⁹⁶ Electronic Data Systems Corp. and Hewlett-Packard were suffering stock price declines as a result of concerns with their accounting practices.³⁹⁷ Other firms were suffering from old-fashioned market failures. Consecro became the third largest bankruptcy in history in 2002.³⁹⁸ Polaroid filed for bankruptcy in September of 2001.³⁹⁹ Kmart filed for Chapter 11 bankruptcy on January 22, 2002, marking the largest retail bankruptcy in history.⁴⁰⁰ Kmart had almost \$40 billion in annual sales before filing for bankruptcy. As concern arose about Kmart's continued viability increased, its share prices dropped dramatically, by seventy percent in a single week.⁴⁰¹ The company later reported that its executives had engaged in various malpractices to enrich themselves and to avoid paying the company's bills as they came due.⁴⁰² Executives were indicted by the Justice Department and others were sued by the SEC for accounting malpractices.⁴⁰³ There was also bad news for investors interested in the airlines industry. US Airways declared bankruptcy, and American Airlines announced that it was laying-off 7,000 workers.⁴⁰⁴ United Airlines filed for bankruptcy in December of 2002. This was the largest bankruptcy of an airline in

³⁹⁶ Deborah Solomon, et al., *HealthSouth Faked \$1.4 Billion Profits, The SEC Alleges*, WALL ST. J., Mar. 20, 2003, at A1.

³⁹⁷ Gary McWilliams, *EDS Ousts Brown, Names New CEO*, WALL ST. J., Mar. 21, 2003, at A3; Richard Waters, *Renewed Reporting Concerns Hit HP*, FIN. TIMES, Mar. 14, 2003, at 17.

³⁹⁸ Business, FIN. TIMES, Dec. 19, 2002, at 1; see Adrian Michaels, *Consecro Files for Bankruptcy Protection*, FIN. TIMES, Dec. 19, 2002, at 20.

³⁹⁹ Warfield, et al., *supra* note 327, at R12.

⁴⁰⁰ *What's News*, WALL ST. J., Jan. 22, 2002, at A1.

⁴⁰¹ Andrew Edgecliffe-Johnson, *Kmart Stock Plunges as Bankruptcy Threat Looms*, FIN. TIMES, Jan. 17, 2002, at 1., available at Lexis NewsGroup File, <http://www.lexis.com> (last visit Mar. 31, 2003) (on file with the North Carolina Journal of International Law and Commercial Regulation).

⁴⁰² Amy Merrick, *Kmart Files Restructuring Plan After Conducting Internal Probe*, WALL ST. J., Jan. 27, 2003, at A3.

⁴⁰³ Amy Merrick, *U.S. Indicts 2 Ex-Executives of Kmart Corp.*, WALL ST. J., Feb. 27, 2003, at A3.

⁴⁰⁴ Edward Wong, *American Airlines to Cut Jobs, Planes and Flights*, N.Y. TIMES, Aug. 14, 2002, at C1.

history.⁴⁰⁵

Losses were also mounting as further management failures were exposed by the downturn in the economy. In 2001, there were 257 bankruptcies of publicly owned companies. This was a record high.⁴⁰⁶ Other large firms, though not bankrupt, were staggering. Ford Motor Company announced a fourth quarter loss of \$5.07 billion for 2001. It also warned of further losses in 2002,⁴⁰⁷ and the company announced that it was writing off \$4 billion, closing plants, and dropping 10,000 employees and thousands of contractor jobs.⁴⁰⁸ Another \$1.7 billion in off-balance sheet exposures were also being transferred back to the balance sheet as accounting standards tightened.⁴⁰⁹ Computer firms announced the layoff of 31,000 employees on a single day.⁴¹⁰ Corporate bond defaults reached a year-to-date record of \$140 billion in September, 2002. There were fifty fallen angels in that group, *i.e.*, companies whose bond ratings dropped from investment grade to junk bond status.⁴¹¹

The Aftermath

Politics Intervene

The Enron scandal became a political football as regulators and politicians vied with each other for headlines in exposing scandals and reacting with ever increasing volume in professed

⁴⁰⁵ Mary Chung & Lisa Fingeret-Roth, *Analysts See Hopeful Signs Beyond the Debris*, FIN. TIMES (London), Dec. 14, 2002, at 2, available at Lexis NewsGroup File <http://www.lexis.com> (last visit Mar. 31, 2003) (on file with the North Carolina Journal of International Law and Commercial Regulation).

⁴⁰⁶ FOX, *supra* note 167, at 288. The record level of bankruptcies carried over into 2003. Jenny Wiggins, *Bankruptcies Forecast to Stay Near Record*, FIN. TIMES Feb. 27, 2003, at 15.

⁴⁰⁷ *What's News*, WALL ST. J., Jan. 18, 2002, at A1; see Norihiko Shirouzu, *Ford Reports Losses for Quarter Year, Warns About 2002*, WALL ST. J., Jan. 18, 2002, at A2.

⁴⁰⁸ *What's News*, WALL ST. J., Jan. 10, 2002, at A1; see Norihiko Shirouzu, *Ford Overhaul Could Cost Up To 4 Billion*, WALL ST. J., Jan. 10, 2002, at A3.

⁴⁰⁹ Jeremy Grant & Andrew Hill, *Ford Admits It Faces \$1.7bn Hit to Accounts*, FIN. TIMES, Mar. 17, 2003, at 12.

⁴¹⁰ ANDERS, *supra* note 175, at 122.

⁴¹¹ Aline van Duyn, *Paper Debt Defaults Hit Record \$140bn*, FIN. TIMES, Sept. 30, 2002, at 25.

outrage. The Enron scandal was fueled by hotly contested state and national elections that witnessed politicians of both parties trying to “out-Enron” their opponents in condemning corporate executives involved in the burgeoning scandals.⁴¹² President George W. Bush found it necessary to deliver a televised address on Wall Street on the importance of corporate responsibility in which he stated he sought to increase penalties for executives who break the law.⁴¹³

The New York Attorney General, Eliot Spitzer, turned himself into a national figure by assuming control over the regulation of the securities industry. Other state regulators quickly jumped in, returning regulation to the Blue Sky laws of yester years.⁴¹⁴

⁴¹² Markham, *supra* note 220; Richard Schmitt & Jerry Markon, *Wall Street Enforcers Uphold Giuliani Model, Prosecutors Spin Novel Theories, Play to Court of Public Opinion, In Pursuing Alleged Wrongdoings*, WALL ST. J., Oct. 23, 2002, at C1.

⁴¹³ Jane Cummings, et al., *Securities Threat, Bush Crackdown on Business Fraud Signals New Era*, WALL ST. J., July 10, 2002 at A1. President Bush was himself the target of criticism for loans used to buy stock of Harken Energy Corp. and for selling stock in that company at a profit two months before it announced a \$23.2 million quarterly loss. This occurred when Bush was a director and consultant to the Harken Energy Corp. in the 1980s. President Bush, however, pointed out that the stock recovered and was trading at twice the price he sold it at several months later. Lydia Adetunji, *White House Defends Low-Interest Loans to Bush*, FIN. TIMES, July 12, 2002, at 1. Indeed, anyone in public life who had served in a corporation at any time was subject to attack. Vice President Dick Cheney was under criticism for his stewardship at Halliburton Corporation, a Houston energy company. A lawsuit brought by Judicial Watch, a private interest group, was seeking to prove that he conspired to defraud investors by questionable accounting practices. Those practices had been implemented with the assistance of Arthur Andersen resulting in inflated income and earnings. The lawsuit claimed that Halliburton had booked income from construction project overruns that were in dispute. Gerard Baker, *A Washington Insider*, FIN. TIMES, July 13–14, 2002, at 7.

⁴¹⁴ Russell Gold & Andrew Caffrey, *United Crime Busters*, WALL ST. J., Aug. 1, 2002, at B1. Among the absurdities of these investigations was the allocation by state regulators amongst themselves of particular firms to investigate. Utah got Goldman Sachs and Massachusetts was assigned Credit Suisse First Boston. Craig, *supra* note 216; Patrick McGeehan, *States Talk Tough, Wall St. Sweats*, N.Y. TIMES, Oct. 20, 2002, §3, at 1. We have gone retrograde in other ways. Before World War I, accounting doctrine was based on the precept of “anticipate no profits and provide for all possible losses.” *Cf.* *Space Controls, Inc. v. Commissioner*, 322 F.2d 144, 148 n.12 (5th Cir. 1963) (citing rule). This principle of conservatism required assets to be carried on the balance sheet at their historical cost rather than their market value. Transactions had to be accounted for on a cash basis. These conservative principles came under criticism during the inflationary period of the 1920s, but gained favor again during the deflation that occurred during the Great Depression. Modern accounting, however, shifted its focus to the

Although few Americans understood the accounting issues involved, they were collectively outraged. Using some inscrutable formula, the Brookings Institute estimated that the corporate governance scandals had cost the United States economy \$35 billion, which would be equal to a \$10 per barrel rise in the price of oil.⁴¹⁵ Corporate governance became a cottage industry for news reports and conferences.

The elaborate self-regulatory system, the whistleblower requirements for accountants imposed by congress, and the SEC mandated auditor rules having failed, the government began to bludgeon the accounting firms into becoming policeman. The destruction of Arthur Andersen & Co. was the first strike.⁴¹⁶ The SEC also announced that it will be naming firms and not just individual audit partners in future disciplinary proceedings.⁴¹⁷

Congress was also reacting, but the SEC's chairman, Harvey Pitt, sought to cut off any hasty legislative action, "By proposing

income statement, which led to "accrual" accounting. WILLIAM L. CARY & MELVIN A. EISENBERGG, *CORPORATIONS, CASES AND MATERIALS* 1318-19 (6th unabridged ed. 1988). Accrual accounting requires a corporation to recognize revenues when earned and liabilities when incurred. This means that income must be recorded when a sale is made (*i.e.*, when the goods are transferred or services rendered) even if cash is not received until later. *See generally In re Clinger & Co.*, Securities Exchange Act Release No. 393390 (S.E.C. 1997) ("The accrual method of accounting requires that revenue be recognized when the earnings process is complete and an exchange has taken place, as opposed to the 'cash' method of accounting, which allows for revenue recognition only when a cash payment is actually received."). Now, accounting critics are asserting that accrual accounting has fostered many of the accounting failures now of concern and that we should turn to the cash flow statement as the key basis for measuring the company's operations. This is simply a return to cash basis accounting used in the 1920s. The author leaves for others to explain why we have different financial accounting and tax accounting systems that are used dually by corporations. Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1341-42 (1996). A corporation may thus have pro forma (non-GAAP reports), accrual accounting statements under GAAP and a cash flow, *a.k.a.*, cash basis statement, as well as separate tax accounting. The need for so many suggests the inaccuracy and weakness of all as a measure of management.

⁴¹⁵ Allen Beattle, *Corporate Scandals Will Cost US 35 Billion*, FIN. TIMES, Sep. 5, 2002, at 1.

⁴¹⁶ That prosecution was incredibly shortsighted, costing investors hundreds of millions of dollars that could have been recovered from Andersen in settlements if the accounting firm had not been destroyed by the government. *See Markham, supra* note 220 (describing the failure of judgment in bringing the Andersen prosecution).

⁴¹⁷ SEC Enforcement, 34 SEC. REG. & L. REP. 2019 (Dec. 16, 2002).

that a new body should be created that would be dominated by public members and would have the power to discipline accountants and maintain quality control standards.”⁴¹⁸ That proposal was considered too mild, and Chairman Pitt came under attack for maintaining relations with the accounting industry that he represented while in practice.⁴¹⁹ The result was the enactment of the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act demanded higher auditor independence requirements⁴²⁰ and strengthened the audit committees of public companies.⁴²¹ The act also created a new Public Company Accounting Oversight Board (PCAOB) (or to some, “Peekaboo”)⁴²² that was to maintain auditor oversight, replacing the self-regulatory model for that function.⁴²³

⁴¹⁸ Randall Smith & Michael Schroeder, *Pitt's SEC Plan for Self-Regulation of Accountants May Have Pitfalls*, WALL ST. J., Jan. 18, 2002, at C15.

⁴¹⁹ James Jaffe, *Pitt and Stalled Reform*, CHI. TRIB., Jan. 5, 2003, Perspective at 1. For a description of that representation, see LEVITT, *supra* note 114, at 119. Chairman Pitt also came under fire for seeking higher pay for SEC employees and cabinet status. Janet Kidd Stewart & Frank James, *Silver Lining Found in Pitt*, CHI. TRIB., Nov. 7, 2002, Business at 1.

⁴²⁰ The SEC later adopted regulations under that Act that would cause an auditor to review its own work. Michael Schroeder, *SEC Clears Rules Limiting Auditors From Offering Consulting Services*, WALL ST. J., Jan. 23, 2003, at C9.

⁴²¹ Audit committees must be composed of independent directors experienced in finance and accounting. *Audit Committee Financial Experts, Ethics Codes Must be Disclosed SEC Says*, 35 SEC. REG. & L. REP. NO. 3, at 113 (Jan. 20, 2003). This seems strange because independent board members are not able to devote full time to audit work. This makes them vulnerable to management manipulation. If the independent directors do make it a full time job, then they have lost their independence.

⁴²² Judith Burns, *Deals and Deal Makers: Accounting Board Tackles Its Mission*, WALL ST. J., Jan. 8, 2003, at C5.

⁴²³ Scot J. Paltrow & Jonathan Weil, *Accounting Industry Review Board Votes to End Its Existence in Protest*, WALL ST. J., Jan. 23, 2002, at A2. The new accounting authority immediately ran into trouble when Harvey Pitt selected William Webster to be the head of that body. Webster, a former federal judge and FBI and CIA chairman, was found to have been accused of acting fraudulently in his role as a member of an audit committee for a public company. Both Pitt and Webster were forced to resign. Holman W. Jenkins, Jr., *The Harvey Thrill Ride, Cont'd.*, WALL ST. J., Nov. 6, 2002, at A23. It seemed that anyone even remotely connected with business was now the target of one full disclosure lapse or another.

PCAOB and FASB Too

PCAOB is a strange creature. It in some ways compares to a bank regulator.⁴²⁴ Accounting firms must register with it and be inspected by it to assure compliance with audit standards. Those firms not in compliance may be sanctioned by PCAOB.⁴²⁵ Audit firms are restricted in their non-audit activities in a manner similar to those already included in SEC rules, and PCAOB, not the industry, will set GAAS.⁴²⁶ This program seemed to be designed to make the accounting firms as unprofitable as possible by increasing expenses and restricting revenues, therefore, effectively turning accounting into something akin to a government agency, but without immunity or the deep pockets of the taxpayers.

Who would want to be an accountant? The answer it seems is a declining number. Between 1993 and 1999, the number of persons taking CPA exams declined by nearly thirty percent and the percentage of students majoring in accounting was cut in half in the 1990s.⁴²⁷ Clearly, this is an industry in trouble. But why would a risk adverse accountant, which is the government's perception of what an accountant should be, enter this profession? Their character, fortune, and freedom are all at risk whenever a company fails or its management misbehaves.

The FASB will apparently continue its role of setting accounting principles in the form of GAAP. It will have some meaty issues to contend with in this new environment. One certainly controversial matter is the expensing of options.⁴²⁸ That

⁴²⁴ See David Rogers, *Big Salaries for Oversight Panel are Questioned on Capitol Hill*, WALL ST. J., Jan. 27, 2003, at A4. One difference between PCAOB and other regulators were the enormous salaries being paid to its members. The PCAOB chairman was to receive \$560,000 per year. *Id.* Not up to Enron standards, but not bad.

⁴²⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

⁴²⁶ *Id.*

⁴²⁷ LEVITT, *supra* note 114, at 130.

⁴²⁸ Floyd Norris, *Promises of a Nimbler Accounting Board*, N.Y. TIMES, Apr. 25, 2002, at C5; see also Wick Simmons, *The Best Option*, WALL ST. J., Jan. 31, 2003, at A10 (asserting that expensing of options will impair American commerce). But see Janet Whitman, *Stock Options Are Fading Away as a Hot Issue*, WALL ST. J., Jan. 29, 2003, at B15 (the controversy over expensing options is fading); Ben White, *Stock Options Becoming Pay-Plan Dinosaurs?*, WASH. POST, Jan. 31, 2003, at E1 (companies are using

issue demonstrates how good intentions and ill-considered legislation can easily run amuck. Options as executive compensation became popular for many reasons. Congress decided that tax penalties should be imposed on salary payments in excess of \$1 million.⁴²⁹ This made options attractive to high roller executives because there was no cap, and options can have tax advantages.⁴³⁰ Options were also attractive to start-up companies and their employees as a way of attracting motivated employees who would be well compensated in a market bubble such as that of the 1990s.⁴³¹ Some eighty percent of executive compensation was paid in stock options as the new century began.⁴³²

The use of options also satisfied a demand by corporate critics that executives be made more accountable to shareholders tying compensation to the share price. In fact, the opposite occurred.⁴³³ Shareholders, at least most small investors, have a long-range investment goal. They buy and hold. In contrast, a senior executive seeks to receive as much cash as possible in as short as time as possible for retirement and to gratify a lifestyle they demand from their business success.⁴³⁴ These executives have a

alternative incentive programs).

⁴²⁹ Omnibus Revenue Reconciliation Bill of 1993, H.R. 2264, 103d Cong., 1st Sess. (1993). This legislation prohibits a corporation from deducting more than \$1 million for an executive's salary without, among other things, obtaining shareholder approval. This is a vote that a highly paid executive would not want to occur. *See generally* AMEY STONE & MIKE BREWSTER, *KING OF CAPITAL, SANDY WEILL AND THE MAKING OF CITIGROUP*, 246 (2002) (describing the salary cap).

⁴³⁰ *See* Janice Revell, *Mo' Money, Fewer Problems*, *FORTUNE*, Mar. 31, 2003, at 34 (describing how the \$1 million limitation on deductions of executive salary encouraged use of options that were not so limited).

⁴³¹ LEVITT, *supra* note 114, at 212.

⁴³² *Id.* at 111.

⁴³³ *See generally* Remarks of SEC Chairman Harvey Pitt at the Inaugural Lecture of the JD/MBA Lecture Series at the Kellogg Graduate School of Management and Northwestern Law School, Chicago, Ill., Apr. 4, 2002 (discussing concerns with the use of options as executive compensation).

⁴³⁴ As an example of the incredible size of option payouts, Michael Eisner at Walt Disney Co. exercised options in 2000 worth some \$60 million and was holding additional options valued at \$266 million. HAZEN & MARKHAM, *supra* note 271, at 315-316. Larry Ellison, the head of Oracle Corp., made \$706 million on his options. Michael Dell of Dell Computer made \$233 million, Sanford Weill at Citigroup made \$220 million, and Thomas Siebel of Siebel Systems made \$174 million from option grants.

tremendous incentive to boost their stock on a short-term basis so that they can realize cash from their options. In order to accomplish that goal, earnings must continually increase, giving rise to imaginative schemes to manage or manipulate accounts. Another downside in using options as a compensation incentive is that their exercise dilutes the holdings of the long-term investors, a matter that a liquidating executive will care little about.⁴³⁵

The FASB, in the early 1990s, proposed to require corporations to treat option grants as an expense on the income statement and as a charge against earnings.⁴³⁶ This met widespread opposition, not only from overpaid executives, but also employees and participants in the numerous startup companies that were seeking to exploit the Internet.⁴³⁷ After this became a controversial political football in Congress, the FASB backed off the proposal.⁴³⁸

The issue was raised anew with the Enron debacle, although it is not clear how option grants caused that company's demise.⁴³⁹

Matt Murray, *Options Frenzy: What Went Wrong?*, WALL ST. J., Dec. 17, 2002, at B1.

⁴³⁵ Some executives have been able to "double dip" from options on tracking stock. Two Sprint executives made a total of \$137 million on Sprint Wireless tracking stock, while an executive at Perkin-Elmer made \$62 million. John A. Byrne, *Extra Helpings on the Gravy Train*, BUS. WEEK, Apr. 22, 2002, at 39.

⁴³⁶ LEVITT, *supra* note 114, at 107–108.

⁴³⁷ *Id.* at 110–11.

⁴³⁸ *Id.* at 109–10.

⁴³⁹ Enron executives made \$1.4 billion from their options in 2000, which were then largely sheltered by some now dubious tax gimmicks. Deborah Solomon, *Enron Cut Tax Bill by \$2 billion in Working Around IRS Rules*, WALL ST. J., Feb. 14, 2003, at A3. This was not, however, a cash drain on the company, and it is not clear how expensing options would have changed the situation, other than perhaps assisting a decline in the stock price. Among the concerns that arose from the Enron bankruptcy were the large losses of its employees who had concentrated large amounts of Enron stock in their self-directed 401(k) pension plans, while executives were profiting by millions of dollars in stock sales obtained by option grants. See Altman, *supra* note 231 (describing some of these sales). See generally Floyd Norris, *The Markets: Stocks & Bonds After Two Year Drop In Markets, Calendar Turns on Note of Hope*, N.Y. TIMES, Jan. 1, 2002, at A1 (Enron stock values dropped more than \$61 billion). The company retirement plan for Enron employees limited the amount of purchases of its own stock. *Pensions in America, The Miracle of Diversity*, THE ECONOMIST, Dec. 15, 2001, at 10. The employees were not so prudent. They held about fifty-four percent of their investments in their Section 401(k) accounts in Enron stock. The value of that stock dropped from \$83 per share in 2000 to less than one dollar just before the company declared bankruptcy. Employees had also been investing additional Enron stock through an employee stock purchase

After, the collapse of Enron, several companies, including General Electric and Coca-Cola, announced that they would expense option in their future financial reports.⁴⁴⁰ The International Accounting Standards Board also proposed that companies deduct the costs of stock options from profits, but opposition remains.⁴⁴¹ The accounting firms remain divided on the issue.⁴⁴² FASB is now in the process of deciding how to expense options.⁴⁴³

Resolving that issue will call into question its role in the post-Enron era. Is it to be a social engineer, decreeing ways to curb executive compensation, or is it an accounting body that will

program. One individual at Enron had his investments drop from \$1.3 million to \$8,200 in value before the company declared bankruptcy. Losses were compounded because the 401(k) plans were frozen due to a plan administrator turnover during the crash of the Enron stock and employees could not sell before it was too late. Executives selling option stock were not so constricted, but the Sarbanes-Oxley Act subsequently imposed such a restriction. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 § 306(a)(2). The losses at Enron led to calls to restrict the percentage of holdings of such employees to less than twenty-five percent of their total investment. This proposal overlooked, however, the fact that employees had bought stock ownership in their company in order to share in the growth. There were also many millionaires who had been created by such stocks as Wal-Mart and Microsoft. By 1997, Microsoft alone had produced 21,000 millionaire employees as the result of the rise in its stock value. This was two-thirds of the company's employees. HAYNES JOHNSON, *THE BEST OF TIMES, AMERICA IN THE CLINTON YEARS 50* (2001). Microsoft stock, however, dropped from \$120 per share to below \$40 at the end of 2000. *Id.* at 72. A survey found that other large companies had large concentrations of company stock in employee 401(k) plans. These included Abbott Laboratories (82 percent); Anheuser-Busch (83 percent), McDonalds (74.3 percent) and Procter & Gamble (91.5 percent). Ellen E. Schultz & Theo Francis, *Companies' Hot Tax Break: 401(k)s*, WALL ST. J., Jan. 31, 2002, at C1.

⁴⁴⁰ Alfred Rappaport, *Manager's Journal: Choosing Useful Options*, WALL ST. J., Aug. 1, 2002, at B2. Only some twenty-one percent of companies whose profits would be reduced by less than one percent have agreed to expense options. Few companies have chosen to do so where the result would have a much larger effect on earnings. Janet Whitman, *Stock Options are Fading Away as a Hot Issue*, WALL ST. J., Jan. 29, 2003, at B15.

⁴⁴¹ Andrew Parker, et al., *Foreign Regulators Grids for Tougher Rules*, FIN. TIMES, Nov. 7, 2002, at 21.

⁴⁴² Cassell Bryan-Low, *Stock Options are Divisive Subject in Accounting*, WALL ST. J., Feb. 18, 2003, at C9.

⁴⁴³ Placing a value on the option will be another issue, some suggest using the Black-Scholes economic model. LEVITT, *supra* note 114, at 108. For criticism of such an approach, see Robert Bartley, *Thinking Things Over: The Options-Accounting Sideshow*, WALL ST. J., July 29, 2002, at A15. In *Seinfeld v. Bartz*, 322 F.3d 693 (9th Cir. 2003), the court dismissed claims that a proxy statement was misleading because it did not disclose the value of options granted to executives under the Black-Scholes model.

provide guidance on how companies account for their business in a way that is clear, fair, and accurate? The latter role may be used to justify the first, but that might be just another accounting trick designed to accomplish an ulterior goal.

The Accountant as Policeman Revisited

The Role of the Accountant

The full disclosure model for the federal securities laws hinges on the accountant's opinion. That has proved to be a fallacy in assuring that investors are informed of the actual condition of their company. Accountants have proved time after time that they are not effective policeman. The savings and loan crisis of the 1980s was blamed on the lapses of accountants who failed to detect the many fraudulent and outrageous practices of numerous savings & loan organizations that were captured by gangs of criminals.⁴⁴⁴ Three accounting firms made combined settlements in that fiasco that totaled some \$900 million.⁴⁴⁵ Even before the current debacles, accounting firms were spending some nineteen percent of their revenues on litigation costs.⁴⁴⁶

Accountants became a deep pocket for investor claims when public companies became bankrupt. That liability was to some extent limited by a Supreme Court decision holding there was no private right of action for books and records violations.⁴⁴⁷ The scienter requirement imposed by the Supreme Court on actions under Rule 10b-5 added another cushion for accountants.⁴⁴⁸ Still another Supreme Court decision rejected aiding and abetting liability that had been the basis for seeking damages from

⁴⁴⁴ For a description of the savings and loan debacle, which might more fairly be blamed on regulators, see III MARKHAM, *supra* note 132, at 166-74; see generally MARTIN MAYER, *THE GREATEST BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY* (1990) (describing abuses).

⁴⁴⁵ Anthony Muio, *An Independent Auditor's Suit for Wrongful Discharge*, 58 ALB. L. REV. 413 (1994).

⁴⁴⁶ *Id.*

⁴⁴⁷ *Touche Ross & Co. v. Redington*, 442 U.S. 560, 574-78 (1979). Liability for filing false documents could still be based on Section 18(a) of 1934, 15 U.S.C. § 78r(a), but that provision allows a good faith defense, and Section 11 of the Securities Act of 1933 also somewhat circumscribes accountant liability. 15 U.S.C. § 77k (2000).

⁴⁴⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 204-05 (1976).

accountants and lawyers in failing company cases.⁴⁴⁹ Further aid was given to the accountants under RICO by the Supreme Court.⁴⁵⁰ The states have divided on whether to impose liability for auditor negligence. Those rejecting such liability focus on the inability of the auditor to assure accuracy of financial statements.⁴⁵¹

With this uncertain background, it seems strange that congress and the SEC would continue to place the burden of assuring disclosure on accountants.⁴⁵² The accountant, who is at the heart of

⁴⁴⁹ Central Bank v. First Interstate Bank, N.A., 511 U.S. 164, 184 (1994).

⁴⁵⁰ Reves v. Ernst & Young, 507 U.S. 170, 182–84 (1993).

⁴⁵¹ See generally *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. Ct. App. 1931) (rejecting negligence liability); *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Sup. Cal. 1992) (rejecting negligence liability but describing approach of courts imposing such liability). Courts in the United Kingdom had held that the auditor owed no duty to subsequent shareholders and that auditors could disclaim responsibility in their opinions. The SEC staff is trying to block the use of such disclaimers in the United States. Jonathan Weil & Silvia Ascarelli, *SEC Likely to Reject limit on Liability*, WALL ST. J., Feb. 28, 2003, at C7.

⁴⁵² Blame is also being placed on other “gatekeepers” who must also be dragooned into becoming informants in order to make full disclosure work. John C. Coffee, Jr., *It's About the Gatekeepers, Stupid*, 57 BUS. L. 1403 (2002). The Sarbanes-Oxley Act of 2002 now seeks to require lawyers to become policeman by requiring lawyers to report to the board of directors where executives may be engaged in violations of the federal securities laws. Thomas Lee Hazen, *Administrative Law Controls on Attorney Practice—A Look at the Securities and Exchange Commission's Lawyer Conduct Rules*, – ADMIN. L. REV. – (forthcoming 2003). Prosecutors are now demanding that corporations waive attorney client privilege in order to avoid prosecution where employees have committed violations. It seems that we must become a nation of informers in order to make full disclosure work. Along those lines, two corporate whistleblowers, one at Enron and another at WorldCom, were named “Persons-of-the-Year” by *Time* magazine. *Persons of the Year*, TIME MAGAZINE, Dec. 30, 2002, at 58. The SEC was directed by the Sarbanes-Oxley Act of 2002 to study the rating agencies (more formally referred to as Nationally Recognized Statistical Ratings Organizations (NRSROs)) and to determine if they too should be deputized “gatekeepers.” For criticism of the role palyed by the NSROs, see Frank Partnoy, *The Paradox of Credit Ratings*, in RICHARD M. LEVICH, ET AL., EDS., RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM Ch.3 (2002). The SEC subsequently sent congress a report on the NRSROs and is issuing a concept release seeking comment on whether those entities should be subject to some form of regulation. This is their punishment for not having predicted the demise of Enron. Congress and the regulators have also ordained analysts with the robe of “gatekeepers” that imposes some quasi-official full disclosure duties. Markham, *supra* note 220. SEC Regulation AC now requires analysts to certify that they believe their reports are accurate and express the analysts’ true opinions. Compensation sources must be disclosed and other restrictions are imposed. In addition, the SEC issued a concept release to require mutual funds to

the full disclosure concept, is supposed to assure that the actual results of public companies operations are accurately reported and portrayed.⁴⁵³ In the eyes of the SEC and the public investor, the accountant is viewed to be the cop on the beat.⁴⁵⁴ In reality, the accountant provides no such service. The accountant simply certifies that the corporation's financial statements were prepared in accordance with GAAP. That certification is based on the accountant's review of the company's records and some verification of their accuracy through sampling, confirmation, or observation.⁴⁵⁵ This provides only minimal assurance that the

study whether another layer of regulation is needed for mutual funds. Deborah Solomon & Karen Damato, *SEC Moves on Mutual-Fund Rules*, WALL ST. J., Feb. 5, 2003, at D9. Firms with trading operations often tape recorded traders' conversations in order to verify their orders in the event of a dispute. Trading room banter in those tapes is now being used as evidence of guilt and posted on government websites. In one famous example of a tape-recorded conversation, a trader stated that he wanted to "lure people into the calm and then just totally fuck em." II MARKHAM, *supra* note 67, at 204. After the analysts' scandals, emails everywhere were being scrutinized and brokerage firms are being required by regulators to keep those emails. Lawyers are now telling clients and even their own associates (since lawyers now are also under federal regulation) that it is dangerous to communicate by this medium and that the telephone should be used lest their comments be viewed in retrospect as evidence of wrongdoing. This all sounds like some kind of totalitarian society, not a free market. Where does it end? Will children also be required to inform on their executive parents in order to better assure full disclosure? "Kids: If you see your mom and dad spending a lot of money and smiling a lot, please call the SEC immediately at their 1-800 hotline." Will executives be required to have cameras in their offices and listening devices piped into the SEC, all in the name of full disclosure? Will business be required to be conducted in dark alleys in order to avoid government surveillance?

⁴⁵³ Accounting has a venerable history. An accountant accompanied Columbus on his voyage to America. I MARKHAM, *supra* note 51, at 8. Luca Pacioli, a Franciscan monk, described double entry bookkeeping methods in 1494, calling it "the method of Venice." *Id.* at 15. The practice of auditing corporate books was brought to America from England and Scotland in the nineteenth century when "chartered" accountants from those countries visited the United States to examine the investments of their clients. Four of what later became the "Big Eight" accounting firms (a number that has since been cut back to four, the "Final Four") were founded by chartered accountants from those countries. *Id.* at 333-34.

⁴⁵⁴ This is illustrated by a recent action brought by the SEC against KPMG. The SEC accuses that accounting firm of only "meekly" challenging the accounting practices of Xerox that resulted in \$6.4 billion in restatements by that corporation. Michaels, *supra* note 340, at 15. What the SEC fails to realize is that accountants are meek by nature. They are not trained to be adversaries to their clients or investigators.

⁴⁵⁵ The audit process has been described as follows:

In a typical audit, a CPA firm may verify the existence of tangible assets,

records are actually accurate or that all information needed by the investor has been disclosed or that it is even understandable. As one court perceptively stated:

An auditor is a watchdog, not a bloodhound As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents The fundamental and primary responsibility for the accuracy [of financial statements] rests upon management. The client engages the auditor, pays for the audit, and communicates with audit personnel throughout the engagement. Because the auditor cannot in the time available become an expert in the client's business and record-keeping systems, the client necessarily furnishes the information base for the audit.⁴⁵⁶

Management, not accountants, is responsible for disclosure, and management is growing less, not more, interested in

observe business activities, and confirm account balances and mathematical computations. It might also examine sample transactions or records to ascertain the accuracy of the client company's financial and accounting systems. For example, auditors often select transactions recorded in the company's books to determine whether the recorded entries are supported by underlying data (vouching). Or, approaching the problem from the opposite perspective, an auditor might choose particular items of data to trace through the client's accounting and bookkeeping process to determine whether the data have been properly recorded and accounted for (tracing).

For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business. The planning and execution of an audit therefore require a high degree of professional skill and judgment. Initially, the CPA firm plans the audit by surveying the client's business operations and accounting systems and making preliminary decisions as to the scope of the audit and what methods and procedures will be used. The firm then evaluates the internal financial control systems of the client and performs compliance tests to determine whether they are functioning properly. Transactions and data are sampled, vouched for, and traced. Throughout the audit process, results are examined and procedures are reevaluated and modified to reflect discoveries made by the auditors. "For example, if the auditor discovers weaknesses in the internal control system of the client, the auditor must plan additional audit procedures which will satisfy himself that the internal control weaknesses have not caused any material misrepresentations in the financial statements.

Bily v. Arthur Young & Co., 834 P.2d 745, 749–50 (Sup. Cal. 1992) (citations omitted).

⁴⁵⁶ *Id.* at 762.

disclosing bad news.⁴⁵⁷ The process is flawed in other respects.⁴⁵⁸ As one senior government official has noted, accounting provides backward looking information, particularly trailing quarterly earnings. "It is driven by accounting standards that are a function of habit and history, of often archaic and abstract principle, and of a shortsighted conviction that it is better to obscure rather than illuminate the real source of earnings."⁴⁵⁹

In any event, the accountant is not an investigator. An accountant does not have subpoena power, nor does an accountant understand how to conduct an investigation. Accountants do not have the time to investigate every annual report of clients. SEC accounting investigations of a limited reporting period take years, while the auditor has only a few months to review those same figures. Unlike the SEC or the Justice Department, accountants cannot compel testimony or offer plea bargains to uncover wrongdoing. Rather, accountants are limited to a few cursory tests for verifying data.

Perhaps the largest flaw in the disclosure model is that accounting statements are management tools, not investigative reports. Accounting reports were developed in order to allow management to make more informed decisions and to better manage the business by taking a periodic accounting of assets, revenue and expenses. They may also provide creditors with some limited third party verification on the finances of the company, a very narrow function. In the best of circumstances, this function does not assure management integrity and certainly is not a

⁴⁵⁷ Silvia Ascarelli, *Companies Show Little Inclination to Disclose More*, WALL ST. J., Feb. 5, 2003, at C5.

⁴⁵⁸ The consolidation of accounting firms into the big four (the "final four") created an oligopoly, or perhaps an oligarchy given their role, for administering the SEC audit business, which may not be a very healthy economic model for such work.

⁴⁵⁹ See *Treasury Official Sees Need for Relevant Disclosure, Supports SEC Proposals*, FED. SEC. L. REP. No. 2054 (2002) (describing speech of Treasury Undersecretary for Domestic Finance Peter Fisher before the Securities Industry Association). Forward looking reports were also criticized because management has a tendency to exaggerate and because they focused investors on short term results. Coca Cola announced that it would no longer make quarterly profit forecasts. Betty Liu & Andrew Hill, *Coca-Cola Attacks Wall ST Focus on Short-Term Outlook*, FIN. TIMES (London), Dec. 14-15, 2002, at 1. Like Regulation FD, see *supra* note 114, this is another blow to an informed market. Soon, all that will be left are SEC mandated disclosures that will allow management to ignore the future and concentrate on the past.

promise of investor wealth or an insurance policy against management failures or market down turns. Moreover, the accountants are employed by the company they audit and are dependent on its good will for continued business.⁴⁶⁰ The accountant's client is management, not shareholders, and no amount of legislation can change that stark fact. Arthur Andersen, for example, had earned \$52 million in fees from Enron in the year prior to its demise.⁴⁶¹ There is also a strong inclination to trust your client and to aid the client whenever possible. This relationship is not an adversarial one, such as those the SEC or other government agencies investigate.⁴⁶²

PCAOB is supposed to fix the system and force accountants to be policeman in their audits. Does anyone seriously believe that this board will be able to monitor the auditing of thousands of public companies to assure that accountants are acting as policemen, rather than accountants? Of course it cannot, but investors are still being deceived into believing that it will. The Enron debacle and the telecom and dotcom implosions, as well as continuing scandals, by now should have removed any doubts as to the hollowness of the assurance that full disclosure protects investors. That was an impossible dream, and Sarbanes-Oxley only adds more smoke to this vision.⁴⁶³

⁴⁶⁰ In contrast, government policeman are not paid by those they investigate. Their jobs are assured whatever they do. Government police also enjoy considerable immunity from damages in both making improper charges and in failing to bring cases. Can you imagine a lawsuit against the SEC for failing to detect the Enron financial problems before its collapse? Yet, the SEC had all the power of the government to uncover the accounting practices of Enron, including its financial statements and the authority to decree that Enron report whatever information desired by the SEC at any time or place.

⁴⁶¹ Michaels & Peel, *supra* note 341, at 18.

⁴⁶² The destruction of Arthur Andersen has reduced competition and provided leverage for the accounting firms to increase their fees, a cost that will only be passed on to shareholders. Andrew Parker, *PWC Warns Clients on Audit Fees*, FIN. TIMES, Dec. 12, 2002, at 1.

⁴⁶³ Proposals for strengthening the policeman role of accounting included a requirement for rotating clients after a specified period of time and preventing audit partners from being hired by client firms. Cassell Bryan-Low, *Panel Backs Stiff Audit Measures: Consulting Limits, Firm Rotation*, WALL ST. J., Jan. 10, 2003, at C11. The SEC eventually required only rotation of audit partners on audit engagements. *Auditor Independence*, 35 SEC. REG. & L. REP. NO. 4 (BNA), at 160 (Jan. 27, 2003). This change should assure that there is no institutional memory on the audit team and place the accounting firm at a further disadvantage should management want to cook its books.

Adopting a New Model

Information as a Commodity

The New Deal regulatory structure that was supposed to provide investor protection does not work, and patching its skin or adding even more layers of regulation will not make it structurally sound.⁴⁶⁴ The states have now become the default regulators as the full disclosure model crumbles. Eliot Spitzer and the attorney general "wolf packs" have assumed control of market regulation and left the SEC sputtering.⁴⁶⁵ At best, the federal securities laws

History teaches us that post-bubble legislation and regulatory actions cause about as much trouble as the bubble itself. John Micklethwait & Adrian Wooldridge, *Stupid White Men, or the True Revolutionaries of Our Age*, FIN. TIMES, Feb. 22–23, 2003, at 1. The South Sea Bubble in 1720 was pricked by legislation that sought to prevent the formation of speculative enterprises. *Id.*; I MARKHAM, *supra* note 51, at 98–100. That legislation was, thereafter, imposed on the colonies in America, preventing the development of corporate business there until after the Revolution. THOMAS LEE HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, CASES AND MATERIALS 4 (2003). The South Sea Bubble continued to plague America. Andrew Jackson somehow connected it to the Bank of the United States, which he then destroyed. JASON GOODWIN, GREENBACK, THE ALMIGHTY DOLLAR AND THE INVENTION OF AMERICA 172 (2003). That institution had stabilized American finance until Jackson began his attack. The destruction of the Bank and other wrong headed actions by Jackson was followed by the Panic of 1837. I MARKHAM, *supra* note 51, at 141–49.

⁴⁶⁴ The New Deal failed as a model in other respects. Unemployment remained at 14.6 % in 1940 as a result of its attacks on business. MELTZER, *supra* note 128, at 560.

⁴⁶⁵ See *supra* notes 412–423 and accompanying text. This event does not appear to be a transient phenomenon. Spitzer was expanding his actions against the stock analysts. Charles Gasparino, *Spitzer Assigns Top Prosecutor To Probe of CFSB's Quattrone*, WALL ST. J., Feb. 7, 2003, at C4. He announced in January, 2003, that he would be examining the short selling practices of hedge funds. Holman W. Jenkins, Jr., *Short Sellers are People Too!* WALL ST. J., Jan. 29, 2003, at A19. He began an investigation of the credit derivatives market. Henry Sender, *Hedge-Fund Inquiry by Spitzer is Turning to Credit Derivatives*, WALL ST. J., Feb. 7, 2003, at C7. Spitzer was also attacking lawyers for failing to detect abuses. John Caher, *At State Bar Summit, Spitzer Blasts Lawyers on Corporate Scandals*, N.Y. L. J. Jan. 23, 2003, at 1. He announced plans to seek expanded legislative authority to further his control over the securities markets. *New York AG Calls for Corporate Accountability Reforms*, 35 SEC. REG. & L. REP. No. 4 (BNA), at 125 (Jan. 27, 2003). Spitzer was even dictating to the New York Stock Exchange on who was qualified to serve on its board of directors. Charles Gasparino & Randall Smith, *Behind Weill's Almost Directorship at NYSE*, WALL ST. J., Mar. 25, 2003, at C1 (Sandy Weill, the head of Citigroup, was nominated to serve as public director of NYSE but withdrew after objection by Spitzer); Adrian Michaels & Joshua Chaffin, *SEC Looks to Impose Curbs on Watchdogs at State Level*, FIN. TIMES (London), April 14, 2003. The banking regulators were, however, resisting Spitzer's efforts to take

still provide an extra policeman on the block—the SEC. At worst, they promise protections that do not exist and restrict market development, as well as impairing America’s global competitiveness in financial services, an area where we are fast losing our comparative advantage.⁴⁶⁶ Not surprisingly, the financial services industry has announced that 500,000 jobs will be shifted offshore in future years.⁴⁶⁷

Another regulatory model is needed. A simple one is available. It is not a new one, but has been tested over time and

over the regulation of national banks. Greg Ip, *Spitzer Tangles Again with Federal Regulators*, WALL ST. J., Feb. 26, 2003, at A6. The state attorneys general are also vying with the federal government for control over antitrust regulation. See, e.g., *State of New York v. Microsoft Corp.*, 224 F.Supp. 2d 76 (D.D.C. 2002) (describing piggy backing by state attorneys general in federal suits against Microsoft Corp. and demands for tougher settlements than that sought by federal regulators). Christopher Bowe, *Bristol-Myers Settles Antitrust Suit for \$670m*, FIN. TIMES (London), Jan. 8, 2003, at 15 (settlement in antitrust suit brought by state regulators in connection with generic drug competition); *Drug Firm to Pay \$80 Million in Antitrust Suit*, N.Y.U. L. J. Jan. 28, 2003, at 1 (Spitzer settles antitrust claim against a pharmaceutical company on overpayments for drugs); *First USA Reaches Settlement Over Telemarketing Issues*, N.Y.U. L. J., Jan. 2, 2003, at 1 (settlement with New York and 27 other states over deceptive telemarketing to credit card holders). The new SEC chairman announced at his confirmation hearings that he intends to reign in Mr. Spitzer and his brethren. Solomon, *supra* note 114. The SEC has long been in competition with state and local prosecutors. See MURPHY, *supra* note 108, at 153 (competition between SEC and New York District Attorney Thomas E. Dewey over prosecution of Richard Whitney, former NYSE head who stole large sums from a NYSE trust fund for widows).

⁴⁶⁶ Strangely, as exemplified by the Sarbanes-Oxley Act of 2002, Congress seems to have chosen more full disclosure regulations as the means to fix a system that has already been proven to be a failure. Even more reactionary proposals are surfacing in the form of short selling restrictions. John Labate, *Short-Selling Faces Clampdown*, FIN. TIMES, Feb. 20, 2003, at 1. Massachusetts had prohibited such sales in 1836 and Pennsylvania in 1841, but such restrictions were found not to have worked. I MARKHAM, *supra* note 51, at 161. Congress also investigated short selling after the stock market crash of 1929. *Congress Investigates Short Selling Practices*, 11 CONG. DIG., No. 12, at 289. Insider restrictions on short selling were imposed (15 U.S.C. § 78p) and the SEC adopted a “tick test” (17 C.F.R. § 240.1010a-1). See generally David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255 (1990) (short sale rule background and shortcomings). More extreme prohibitions were rejected. Short selling restrictions were rejected altogether in the commodity markets even though farmers were claiming that short sellers were driving prices down below the cost of production. *Commodity Short Selling, Hearing Before the House Committee on Agriculture on H.R. 8829*, 73d Cong., 2d Sess. (1932).

⁴⁶⁷ Michael Schroeder, *More Financial Jobs Go Offshore*, WALL ST. J., May 1, 2003, at A2.

has proved successful. Information should be treated for what is – a commodity. As such, it has value and can be bought and sold just as any other commodity. As is the case for other commodities, the government should not require that this commodity (information about securities) be given away for free or that it be distributed in some particular manner, as is now required by the federal securities laws.⁴⁶⁸

This principle of treating information as a mere commodity was laid down by Chief Justice John Marshall at an early period in our history. In *Laidlaw v. Organ*,⁴⁶⁹ the Supreme Court considered the case of a purchase of tobacco by individuals who possessed knowledge of the signing of the Treaty of Ghent and did not disclose this knowledge to the seller. That news was obtained from the British fleet by one of the purchasers and was valuable information because it would result in a sharp rise in tobacco prices (thirty to fifty percent).⁴⁷⁰ It was argued in that case that “[s]uppression of material circumstances within the knowledge of the vendee, and not accessible to the vendor, is equivalent to fraud, and vitiates the contract.”⁴⁷¹ In rejecting that claim, Justice Marshall, for the Court, stated that:

The question in this case is, whether the intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee, ought to have been communicated by him to the vendor? The court is of opinion that he was not bound to communicate it. It would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties. But at the same time, each party must take care not to say or do any thing

⁴⁶⁸ Of course, those using that free information now will not want to pay for it.

⁴⁶⁹ 15 U.S. 178 (1817).

⁴⁷⁰ As asserted by counsel:

This news was unexpected, even at Washington, much more at New Orleans, the recent scene of the most sanguinary operations of the war. In answer to the question, whether there was any news calculated to enhance the price of the article, the vendee was silent. This reserve, when such a question was asked, was equivalent to a false answer, and as much calculated to deceive as the communication of the most fabulous intelligence.

Id. at 186–90.

⁴⁷¹ *Id.* at 184–85.

tending to impose upon the other. The court thinks that the absolute instruction of the judge was erroneous, and that the question, whether any imposition was practiced by the vendee upon the vendor ought to have been submitted to the jury.⁴⁷²

This is a simple standard that has equal applicability to stocks. If no required disclosures or equal information opportunity exist for tobacco or other farming commodities, why is such a rule needed for stocks? We often hear that there is something special and overridingly important about the capital raising functions of the stock market.⁴⁷³ That idea too does not withstand scrutiny. Farming is the largest business enterprise in America.⁴⁷⁴ It is vital to our economy and our very lives, but full disclosure is not mandated for those persons buying and selling these commodities. The second largest industry in the country is construction.⁴⁷⁵ It too is vital to our daily lives and commerce. There is no SEC type mandated disclosures for construction. Yet, nearly seventy percent of families in America own their own homes,⁴⁷⁶ and those purchases were made without SEC style disclosures or accounting opinions. Automobiles are other big-ticket items that do not require SEC style disclosures.

Admittedly, this more pure market approach is clouded a bit by labeling acts that require warnings or disclosures on consumer goods such as tobacco and alcohol.⁴⁷⁷ Even so, those warnings are

⁴⁷² *Id.* at 194.

⁴⁷³ The justification for the full disclosure model is said to be market efficiency instead of fairness to customers. Steven L. Schwartz, *Private Ordering*, 97 NW. U. L. REV. 319, 346 (2002). This seems strange if one views information to be a commodity. It will be for sale. The market will price it and make its distribution more efficient than a government program that forces the commodity to be given away, using threats of jail as the only incentive. Moreover, if free information makes a market more efficient, then why not require the newspapers to make full disclosure and give their information away without advertising or subscription charges?

⁴⁷⁴ David C. Beeder, *Ag Groups Weigh in at Farm Bill Hearing*, OMAHA WORLD HERALD, June 16, 1995, at B20.

⁴⁷⁵ Lori Valigra, *Building on the Web*, BOSTON GLOBE, June 16, 1999, at D1.

⁴⁷⁶ III MARKHAM, *supra* note 132, at 314.

⁴⁷⁷ Federal Cigarette Labeling and Advertising Act of 1965, 15 U.S.C. § 1333 (2000); Alcoholic Beverage Labeling Act, 27 U.S.C. § 217 (2000). Other federal labeling acts include the: Fair Packaging and Labeling Act, 15 U.S.C. § 1461 (2000); Fur Products Labeling Act, 15 U.S.C. § 69g (2000); Wool Products Labeling Act, 15 U.S.C. § 68e (2000); Federal Hazardous Substance Labeling Act, 15 U.S.C. § 1261 (2000); the

concise and are nowhere as detailed as the disclosures mandated by the SEC, and no accountant's certification is required. Many states also impose disclosure requirements⁴⁷⁸ on items like real estate. Many states now provide for forms disclosing known defects in the sale of a residence. At least in North Carolina, however, even those brief disclosures are voluntary.⁴⁷⁹

This labeling model is also used in the commodity markets regulated by the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act of 1936.⁴⁸⁰ That agency mandates a one-page risk disclosure statement that must be given to customers trading commodity futures or option contracts.⁴⁸¹ These are generic risk disclosures that describe the risks of trading in general terms.⁴⁸² They do not purport to provide

Lanham Act, 15 U.S.C. §§ 1125 & 1304 (2000); and Textile Fiber Products Labeling Act, 15 U.S.C. § 70e (2000).

⁴⁷⁸ State labeling statutes may be preempted by federal requirements. *See, e.g.,* Cipollone v. Liggett Group, Inc., 505 U.S. 504 (1992) (federal warning preempted state warning requirements but did not preempt state fraud laws and warranties); Jones v. Rath Packing Co., 430 U.S. 519 (1977) (considering preemption of California laws by federal Fair Packing and Labeling Act, 15 U.S.C. § 1461).

⁴⁷⁹ N.C. GEN. STAT. § 47E-1 *et. seq.* (2002). Of course, anyone attending a house closing has been appalled and overwhelmed by the disclosure documents required for the mortgage, termites, and other things. Still, we have no SEC mandated accounting statements or a requirement of "full disclosure."

⁴⁸⁰ 7 U.S.C. § 1 *et seq* (2000).

⁴⁸¹ *See e.g.,* 17 C.F.R. § 1.55 (disclosure form for futures traders).

⁴⁸² The risk disclosure form for futures trading (17 C.F.R. § 1.55 (2003)) states that:

The risk of loss in trading commodity futures contracts can be substantial. You should, therefore, carefully consider whether such trading is suitable for you in light of your circumstances and financial resources. You should be aware of the following points:

(1) You may sustain a total loss of the funds that you deposit with your broker to establish or maintain a position in the commodity futures market, and you may incur losses beyond these amounts. If the market moves against your position, you may be called upon by your broker to deposit a substantial amount of additional margin funds, on short notice, in order to maintain your position. If you do not provide the required funds within the time required by your broker, your position may be liquidated at a loss, and you will be liable for any resulting deficit in your account.

(2) Under certain market conditions, you may find it difficult or impossible to liquidate a position. This can occur, for example, when the market reaches a daily price fluctuation limit ("limit move").

a certified accounting statement on pork bellies or the S&P 500 Index that also trades in these markets. Of course, government being what it is, the disclosure form can easily become so complicated and convoluted that customer protection is lost.⁴⁸³

(3) Placing contingent orders, such as “stop-loss” or “stop-limit” orders, will not necessarily limit your losses to the intended amounts, since market conditions on the exchange where the order is placed may make it impossible to execute such orders.

(4) All futures positions involve risk, and a “spread” position may not be less risky than an outright “long” or “short” position.

(5) The high degree of leverage (gearing) that is often obtainable in futures trading because of the small margin requirements can work against you as well as for you. Leverage (gearing) can lead to large losses as well as gains.

(6) You should consult your broker concerning the nature of the protections available to safeguard funds or property deposited for your account. All of the points noted above apply to all futures trading whether foreign or domestic. In addition, if you are contemplating trading foreign futures or options contracts, you should be aware of the following additional risks:

(7) Foreign futures transactions involve executing and clearing trades on a foreign exchange. This is the case even if the foreign exchange is formally “linked” to a domestic exchange, whereby a trade executed on one exchange liquidates or establishes a position on the other exchange. No domestic organization regulates the activities of a foreign exchange, including the execution, delivery, and clearing of transactions on such an exchange, and no domestic regulator has the power to compel enforcement of the rules of the foreign exchange or the laws of the foreign country. Moreover, such laws or regulations will vary depending on the foreign country in which the transaction occurs. For these reasons, customers who trade on foreign exchanges may not be afforded certain of the protections which apply to domestic transactions, including the right to use domestic alternative dispute resolution procedures. In particular, funds received from customers to margin foreign futures transactions may not be provided the same protections as funds received to margin futures transactions on domestic exchanges. Before you trade, you should familiarize yourself with the foreign rules which will apply to your particular transaction.

(8) Finally, you should be aware that the price of any foreign futures or option contract and, therefore, the potential profit and loss resulting therefrom, may be affected by any fluctuation in the foreign exchange rate between the time the order is placed and the foreign futures contract is liquidated or the foreign option contract is liquidated or exercised.

This Brief Statement Cannot, of Course, Disclose all the Risks and Other Aspects of the Commodity Markets.

I hereby acknowledge that I have received and understood this risk disclosure statement.

⁴⁸³ Although many consumers, including this author, are still unclear what “APR” really means under the Truth-In-Lending Act, 15 U.S.C. § 1607 (2002), it does at least

What should an SEC mandated disclosure contain? Certainly, investors should be warned that certification of a corporation's financial statements by a CPA does not assure their accuracy. The fact that few people can outperform the market through individual stock picking should be included, as well as the dangers of analysts' conflicts.⁴⁸⁴

A commodity-based model, if applied to the regulation of securities, should prohibit fraud as seen in the *Laidlaw* case. This requirement is essential to any commodity transaction. Stock and tobacco are no different in that regard. Insider trading poses a more difficult issue. In the commodity model, such a concept in reality does not exist. If one has information unavailable to others, one may generally trade on that information. Indeed, such trading is thought to be desirable because it better prices goods and makes markets more efficient, and no one begrudges a reward to those bringing this information to market. For example, if one discovers a wheat rust in a field that will damage the entire region's crop badly when it spreads, one is perfectly entitled to trade on that information. The result will be to increase prices and signal to the market that there will be a shortage of wheat. Alternate supplies can then be arranged or other adjustments made.⁴⁸⁵

In a commodity model system, companies could use their advertising to sell their stocks to the public. Like all advertising, puffery will be used and consumers will have to deal with that problem, as they do with other advertising.⁴⁸⁶ Where there is fraud and deceit, then remedies and government prosecution should be available. Some companies may choose not to disclose their

provide a concise basis for comparison of interest rates.

⁴⁸⁴ This is not to say that out performing the market cannot happen. Bill Miller, manager of the Legg Mason Value Trust did it for twelve straight years but was still losing money in 2002. *Legg Mason Value Trust Fund Outpaced the S&P 500*, 57 KIPPLINGER'S PERS. FIN., Feb., 2003, at 37; Mark Hulbert, *Strategies*, N.Y. TIMES, Jan. 19, 2003, § 3, at 6.

⁴⁸⁵ The agricultural model is still an imperfect one. Subsidization continues for some commodities despite the Freedom to Farm Act of 1992. Pub. L. No. 104-127, 110 Stat. 888. See generally Michael R. Taylor, *The Emerging Merger of Agricultural and Environmental Policy: Building a New Vision for the Future of American Agriculture*, 20 VA. ENVTL. L. J. 169 (2001) (describing agricultural subsidies).

⁴⁸⁶ The author, for example, has long ago concluded that the advertised remedies for baldness fall short of their claims. He has also had similar experiences with claims for kitchen knives.

finances. Investors must then decide whether to invest without that information. Many investors will elect not to do so. Others may value the company as a random event, investing only if there is a high risk-reward ratio. This is the method by which lotteries and other gambling enterprises operate.

Insider trading, of course, has become a moral issue that the SEC has used since the 1960s to defend the full disclosure concept.⁴⁸⁷ That banner too is frayed but could be adapted to a commodity model for its adherents.⁴⁸⁸ The CFTC conducted a study early in its history to determine whether SEC inside trader prohibitions should be applied to commodity trading. It determined that it should not adopt such a prohibition because it would impair the efficiency of the markets.⁴⁸⁹ For those demanding protection against insider trading by corporate officers, however, the misappropriation theory adopted by the Supreme Court will fit a commodity based regulatory model.⁴⁹⁰ Otherwise,

⁴⁸⁷ An effort had been made to cut the aggressive SEC enforcement program during the Reagan administration. The head of that program, Stanley Sporkin, was eased out to become general counsel at the CIA. This action aroused much criticism by his congressional supporters, and they began an investigation of the personal finances of the SEC chairman. In order to divert their attention, the new enforcement head embarked on an aggressive insider trading program that looked like a safe way to satisfy critics on both sides of the issue. The doctrine of unexpected consequences intervened, however, when this effort unexpectedly turned up the Boesky and related insider trading scandals and culminated in the prosecution of Michael Milken. The enforcement director was not given any reward for this effort. Instead, he was driven from office by claims that he was beating his wife. This interesting scenario is how SEC full disclosure policy was made in Washington, D.C. Jerry W. Markham, *The Lawyer's Bookshelf, Eagle on the Street*, N.Y.U. L. J., Dec. 9, 1991.

⁴⁸⁸ As one critic of full disclosure has noted:

Insider-trading regulation has its primordial introduction in the muck of New Deal securities regulation, which was itself justified on the trumped-up theory that full disclosure was the best way to deal with corporate fraud and deception. Over the years, the benign-sounding idea of passive regulation in the form of full disclosure has morphed into a morass of active regulation. Full disclosure now wraps around – and regulates – corporate governance, accounting, takeovers, investment banking, financial analysts, corporate counsel, and, not least, insider trading.

Henry G. Manne, *The Case for Insider Trading*, WALL ST. J., Mar. 17, 2003, at A14.

⁴⁸⁹ COMMODITY FUTURES TRADING COMMISSION, A STUDY OF THE NATURE, EXTENT AND EFFECTS OF FUTURES TRADING BY PERSONS POSSESSING MATERIAL NONPUBLIC INFORMATION (1986).

⁴⁹⁰ *United States v. O'Hagan*, 521 U.S. 642 (1997).

market information available to anyone, even if accessible by a few, could be freely used to trade,⁴⁹¹ but theft of the information would be prohibited. After all, commodity theft (e.g., cattle rustling) is prohibited, and that prohibition is everywhere applauded. Indeed, the CFTC used the misappropriation theory to attack futures trading by two individuals based on information they purloined from their employer.⁴⁹²

In all events, the concept of full disclosure under the securities laws needs to be revisited. This statute holds out a promise it cannot deliver. Investors are told that this legislation assures full disclosure.⁴⁹³ It does not. The SEC does not have the resources to examine these disclosures in any depth. It has tried to shift that burden to the accountants, but as shown, the accountant is in no position to assure accuracy. Even where compliance is faithfully made, the act sets the stage for litigation after any dip in the stock's price, providing a bonanza to the class action bar.⁴⁹⁴ Full disclosure requirements also assure that investors will be receiving "junk stock" that poses a speculative risk well beyond the much ostracized junk bonds made popular by Michael Milken.⁴⁹⁵ An initial public offering is almost inevitably a speculative venture

⁴⁹¹ As the Supreme Court has noted, even under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), no duty to disclose arises because of the "mere possession of nonpublic market information." *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

⁴⁹² *CFTC v. Kelly*, Comm. Fut. L. Rep. ¶ 27,465 (S.D.N.Y. 1998); see also *United States v. Dial*, 757 F.2d 163 (7th Cir. 1985) (wire and mail fraud prosecution for front running customer orders).

⁴⁹³ This almost religious belief in full disclosure is exemplified by statements of an SEC chairman, Arthur Levitt: "When the public loses confidence in our markets, or when the reliability of the numbers is diminished, the whole system is jeopardized . . . The sanctity of the numbers and of their reliability must be there." *McNamee, et al.*, *supra* note 325, at 156. The problem is that their sanctity is not there and cannot be assured. So why suggest otherwise to investors?

⁴⁹⁴ Class action lawsuits were claimed to have "contributed to" the loss of \$1.9 trillion in market value in public companies in 2002. D&O insurance costs at General Electric increased to \$22.1 million up from \$5.8 million. Vincent Boland, *Class-Action Lawsuits Add to Market Loss*, FIN. TIMES, Mar. 13, 2003, at 19.

⁴⁹⁵ Of course, as the late Arthur Liman pointed out in his defense of Milken, junk bond holders must be paid off in full in the event of a corporation's failure before the common stockholders receive anything. Yet, no one refers to stock as "junk stock." ARTHUR LIMAN, LAWYER, A LIFE OF COUNSEL AND CONTROVERSY 268 (1998).

with high risks. IPO allocations (“spinning”)⁴⁹⁶ assure that the rewards of a hot issue will be gained by the favored and the losses will be experienced by those in the secondary market. Few of the investors in these ventures will have read the long and convoluted prospectus and financial statements required by the Securities Act of 1933. Conflicts of interest and now Regulation FD assure that no independent and informed review will be made of those documents and disclosures.

Exemptions to the Securities Act of 1933 further assure that customers receive junk stock. Institutions provide loans and capital to corporations through offerings that are exempted from the federal securities laws. Only when that source of capital is exhausted, do issuers seek to tap the public market. Private placements are made in advance of a public offering on favorable terms that allow those qualifying to reap the rewards of an ascending investment. Private creditors can also assure their positions through secured financing and other protective measures. As a result, the federal securities laws have created a trickle down effect, which leaves retail investors with the leftover offerings of “junk” stock.⁴⁹⁷

Of course, a departure from the SEC mandated full disclosure regime will require great faith in market discipline.⁴⁹⁸ There seems to be a general consensus that market discipline will work, but that the process is slow and needs to be augmented by government

⁴⁹⁶ See *supra* note 227 and accompanying text.

⁴⁹⁷ Institutions provide loans and capital to corporations through offerings that are exempted from the federal securities laws. Only when that source of capital is exhausted do issuers seek to tap the public market. Even where institutional investors purchase publicly traded securities, they will be more astute than retail investors in their investment strategy. For example, where there is a sharp market decline many small investors will sell their securities, only to see the market recover shortly afterwards.

⁴⁹⁸ One suggestion has been that dividends should be used to value the business, *i.e.*, the amount and regular payment of dividends would evidence the worth of a company. Jeremy Siegel, *The Dividend Deficit*, WALL ST. J., Feb. 13, 2002, at A20. This idea would be made easier by the elimination of the double tax on dividends. See generally Jane Fuller, *Global Investors*, FIN. TIMES, Jan. 24, 2003, at 24 (describing proposal by President George W. Bush to eliminate personal taxes on corporate dividends). Dividend signaling might be useful but will also give rise to abuses in the form of Ponzi schemes and the robbing of future growth to maintain dividend strength. At the end of the day, it will fall on management to devise the means to gain market confidence. Those that fail will be punished by the market. Those that resort to fraud will also be punished by the SEC and other regulators.

action. The market, however, has shown a far superior ability to discipline itself than all of the state and federal securities regulators combined.⁴⁹⁹ As of this writing, not a single wrongdoer in the Enron or other debacles has gone to jail. Yet, the market put Enron out of business some eighteen months ago.⁵⁰⁰ WorldCom and others soon followed. Those results would seem to undercut claims that government regulation is more efficient.

This is not to suggest that there is not an important role for the SEC to play. The agency should be redirected to pursuing fraud and dropping its command and control efforts to guide the market. There seems to be more than enough fraud to attack, and by having the SEC concentrate on such conduct, perhaps, state laws could be preempted in order to take financial institutions out from the cross fire of the headline seeking state regulators. The adoption of a commodity-based information model also does not mean that accounting statements will no longer have any value. They will be worth exactly what they provide: a statement by management of the company's financial position with some minimal verification by a third party auditor paid for by the persons being audited. If that information is not satisfactory, then an investor may insist on a new auditor before risking its own money or engage its own auditor and demand access to the books and records of the company, presumably under a confidentiality agreement. Other factors must be used to value the company as well. Analysts could play that role but are so conflicted that they add little value. Analysts' compensation should, therefore, be low

⁴⁹⁹ This is not to say that market solutions will be perfect. They will not be, but they will be better than the false hopes raised by the SEC full disclosure regime.

⁵⁰⁰ The Enron bankruptcy was, at the end of the day, a business failure. As one author notes:

Like GE under Jack Welch, Enron under Ken Lay and Jeff Skilling pursued maximum shareholder value. Like GE's managers, Enron's pursued a plausible and innovative business plan. The firm collapsed for the most mundane of reasons—its managers suffered the behavioral biases of successful entrepreneurs. They overemphasized the upside and lacked patience. They pursued heroic short-term growth numbers that their business plan could not deliver. That pursuit of immediate shareholder value caused them to become risk-prone, engaging in levered speculation, earnings manipulation, and concealment of critical information.

William Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1283 (2002).

in a commodity-based model until their services provide value. Ratings agencies also provide an information service. They are selling a commodity, *i.e.*, their view on the creditworthiness of the customer. It is only worth whatever value is added by that service.

Conclusion

The SEC did nothing to aid recovery during the depression. It was removed from any significant role during World War II. The agency flailed helplessly against the underworld of characters looting public companies during the 1950s and failed in preventing penny stock frauds in Canadian and other mining properties. The SEC lurched from crisis to crisis after it launched itself on an activist course in the 1960s. This could all be forgiven as a natural process. After all, fraud will occur with or without the SEC. What cannot be forgiven is that the SEC had over fifty years to prepare for and prevent the bubble of the 1990s and all the resulting excesses. That was its mission. That was its stress test. It failed. Ancient truth was revealed. Markets go up and they go down. That is what a market does, and it is a necessary part of our economy. Despite the thicket of the incredibly complex regulations it adopted and its aggressive expansion of the full disclosure concept, the SEC could not change that immutable rule. Government efforts to command and control the market process does not make the market more efficient. It only results in more folly. There is nothing radical in that notion. It has been proven time and again from the extremes in the Soviet Union to lesser efforts in Japan and elsewhere.

Full disclosure certainly seemed like an empty promise after the bubble burst in 2000. The demands of full disclosure had forced managers into the role of managing numbers, rather than long-term business goals, or building businesses or the other occupations that management might be expected to manage. If the product was lagging, buy another company to improve the numbers. If debt was too high, move it off the balance sheet in order to improve the numbers. Keep no reserves for hard times because full disclosure did not allow for such reserves, secret or otherwise. If revenue was lagging, fake it. The demands of full disclosure were all consuming and completely geared to short term profits. What a way to run a business!

In all events, full disclosure proved to be a myth for American

investors. It did not stop the market bubble. It did not stop fraud. Investors were not protected by the registration and periodic disclosure requirements of the Securities Exchange Act of 1934.⁵⁰¹ The SEC could assure the accuracy of those statements, and the accountant's certification of SEC Form 10K⁵⁰² did not provide such an assurance. Investors were misled by the SEC into believing that such requirements do provide protection. Full disclosure as investor protection was a fallacy well proved in the last market meltdown. Neither the SEC nor the accounting profession can truly certify the accuracy of accounting statements. Auditors are a useful tool in the process, but have their limitations. The auditor is simply selling information. That information will be as valuable as the audit is thorough and independent.

In order to make full disclosure work, seemingly every public company must be sued periodically by the SEC and their executives must all be indicted. Everyone connected with the securities must be turned into "gatekeepers", read informers. We are being told by scores of academicians and government prosecutors that there is something fundamentally wrong with the corporate governance system that has produced wealth unparalleled in the history of man.⁵⁰³ They advocate their replacement by "outside" directors who know little of the business and cannot take hands-on control, lest they too become insiders. That course is folly. The responsibility for disclosure falls to management, and that should be a market issue. Information is a commodity for management to manage and or to bargain away where appropriate. If management misappropriates that commodity, it may be properly punished. If fraud is at issue, government sanctions can be added to that market discipline. If management fails and mismanages the use of that commodity, the market will respond accordingly, as it did with Enron.

⁵⁰¹ 15 U.S.C. §§ 78l & 78m (2000).

⁵⁰² 17 C.F.R. § 240.13a-1 (2003).

⁵⁰³ As one newspaper editorial comment notes with respect to the corporation: "[T]he company's gainsayers . . . are wrong; the company has been an institution that has changed the world enormously for the better. Indeed, it has been the secret of the west's success." Mickelthwait & Wooldridge, *supra* note 463, at 1.